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JOURNAL OF ACCOUNTANCY

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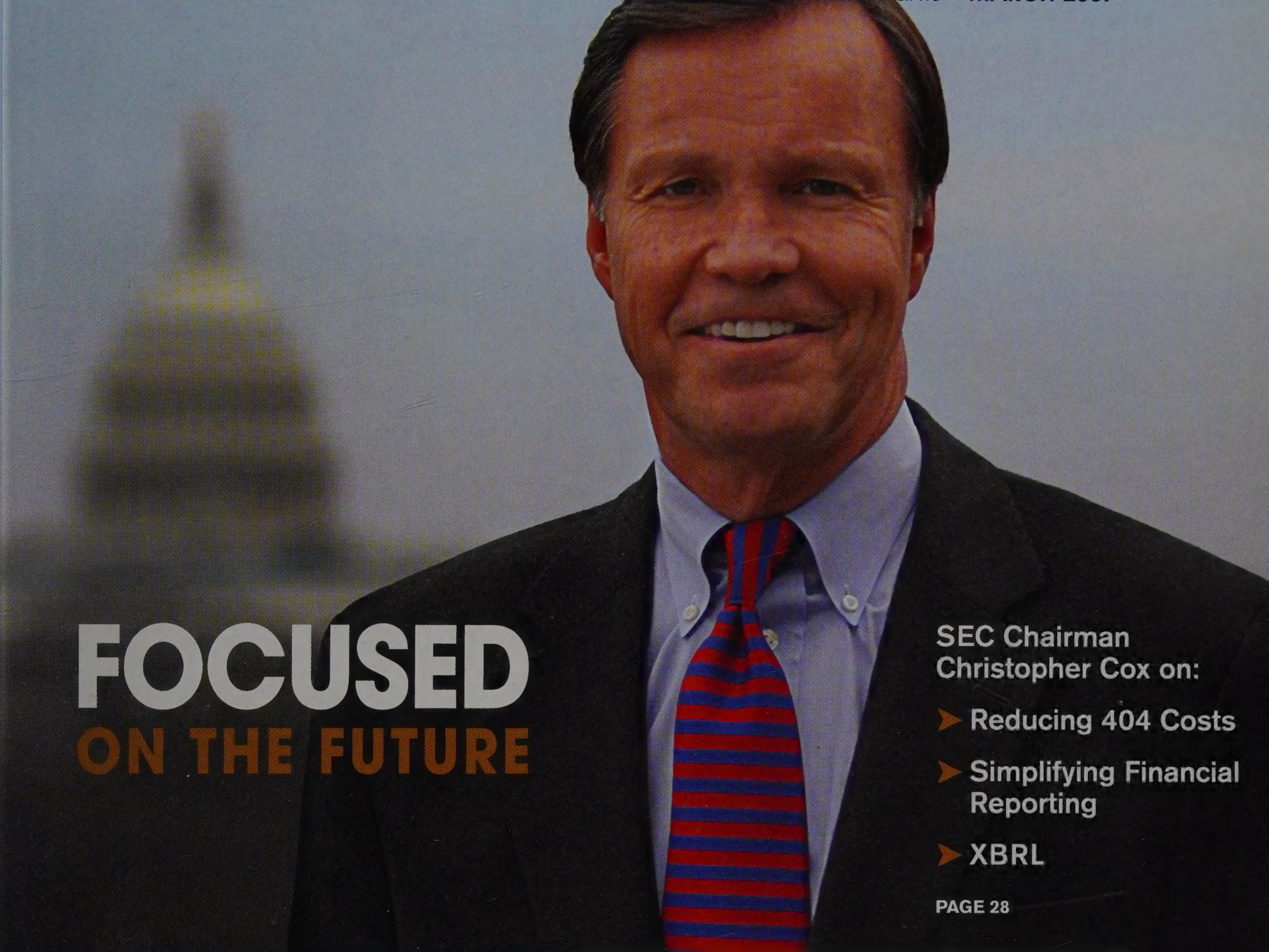

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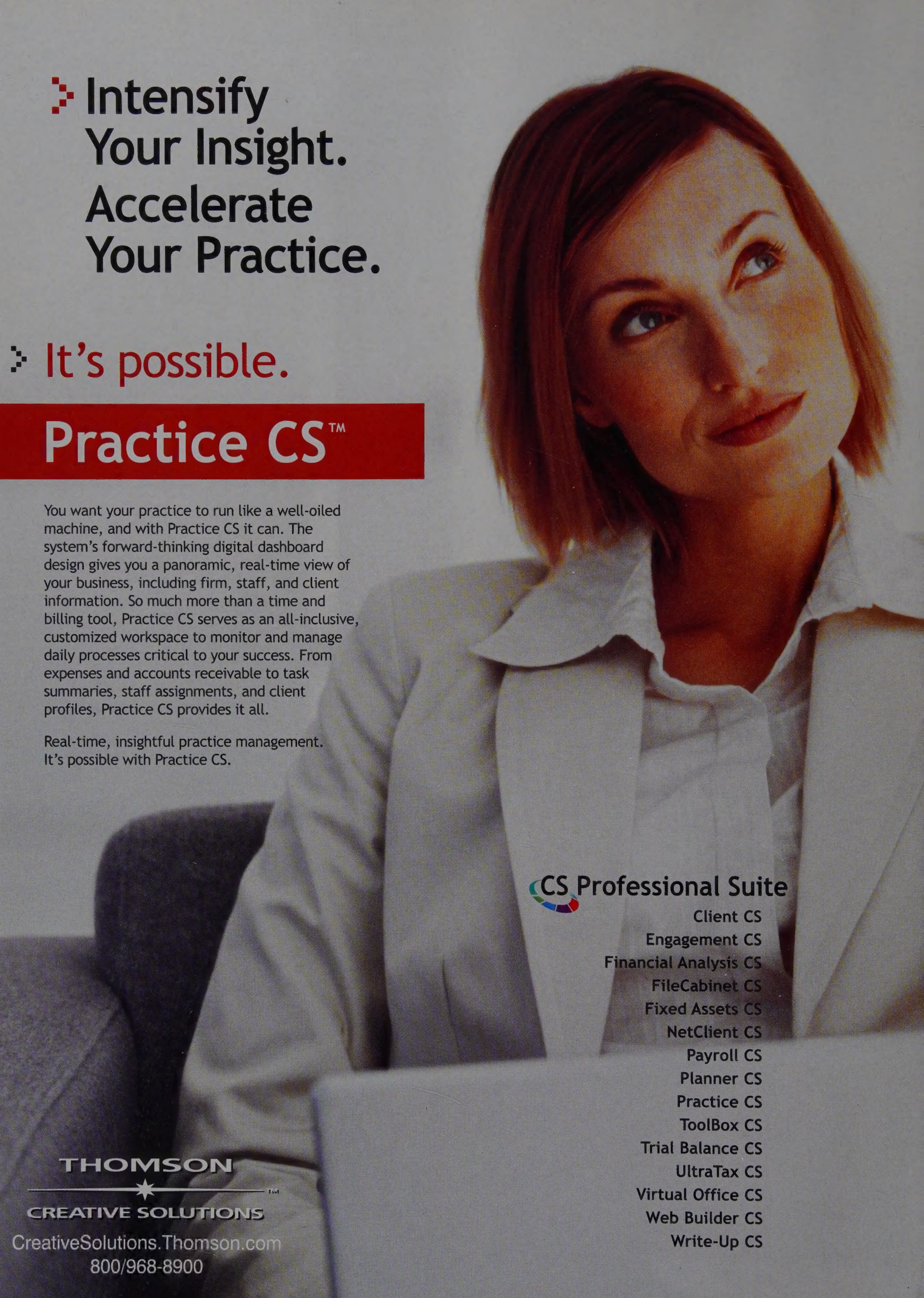
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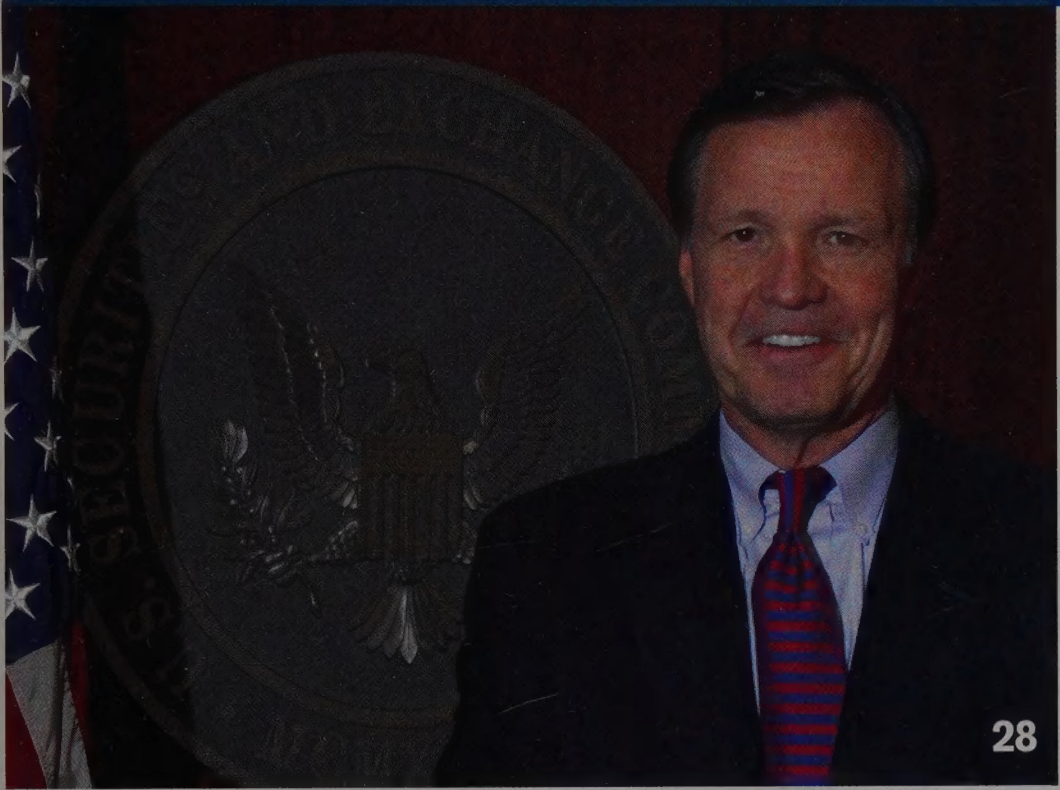

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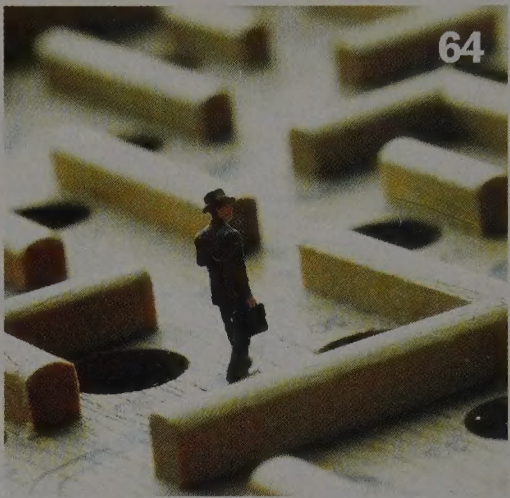

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COLUMNS

OFFICIAL LITERATURE

IN THIS ISSUE

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HIGHLIGHTS

With FASB affirming its implementation date for FIN 48, several organizations, including the AICPA and FASB itself, are producing educational materials or additional guidance to help issuers comply with its new requirements for recognizing and measuring tax assets and liabilities. FASB Interpretation no. 48, *Accounting for Uncertainty in Income Taxes*, is effective for tax years beginning after Dec. 15, 2006.

On Jan. 17, FASB denied requests by the Tax Executives Institute and others to delay implementation of FIN 48 by a year but directed FASB staff to better define FIN 48's provisions relating to "ultimate settlement" of tax positions. The additional guidance will address whether the ability of taxing authorities to reopen an audit affects entities' ability to change their recognition and measurement of uncertain tax positions.

CPA2Biz.com has produced a self-study CPE course on CD-ROM titled *Implementing FIN 48: Issues for Accountants, Auditors and Tax Practitioners* that can be ordered at **www.cpa2biz.com/CS2000/Products/CPA2BIZ/Webcast/Implementing+FIN+48+Issues+CDROM.htm.** Also, members of the AICPA's Tax, Accounting Standards and Audit and Attest teams have produced a FIN 48 practice guide available at **http://tax.aicpa.org/Resources/Professional+Standards+and+Ethics/Practice+Guide+on+Accounting+for+Uncertain+Tax+Positions+Under+FIN+48.htm.**

The AICPA and NASBA drafted proposed revisions to the Uniform Accountancy Act designed to improve the model state legislation's provisions for mobility of CPA practice across state lines and corresponding issues of enforcement. The proposed changes would delete the substantial equivalency requirement that CPAs provide notice of intent to practice in a state other than in their principal place of business. Instead, the CPA and CPA firm would consent to the automatic jurisdiction of the state where practice privileges are being sought. An exposure draft is available at **www.aicpa.org.** Comments are invited through May 15, by e-mail to sbango@aicpa.org and lhaberman@nasba.org.

Fostering confidence in the audit process and aiding investors and the capital markets is the mission of the new Center for Audit Quality (CAQ), a restructuring and expansion of the AICPA's former Center for Public Company Audit Firms (CPCAF). The Center for Audit Quality, an autonomous, nonpartisan, nonprofit organization affiliated with the AICPA, will continue to pursue its objective of serving as the voice of the profession on matters relating to public company audits. The center recognizes that "reliable financial information is the bedrock of investor confidence in capital markets," according to its Web site.

CAQ Executive Director Cynthia Fornelli said the center's "single-minded focus" on public company audits will increase public confidence in and enhance the quality of auditing practices through improved research, communication and education.

The CAQ's 12-member board will include the CEO from the AICPA, chief executives of the six largest CPA firms and two rotating firms, and leaders from the investor and issuer communities. Firms registered with the PCAOB are eligible for membership. Associate membership is available for U.S. CPA firms not registered with the PCAOB.

Firms that were members of CPCAF automatically become members or associate members (depending on their PCAOB registration status) of the Center for Audit Quality as a CPCAF successor and will continue to receive the benefits of membership. While the CPCAF Web site will be for members only, the Center for Audit Quality Web site, **www.thecaq.org**, is for public, non-CPA audiences.

The PCAOB will continue to hold forums on auditing in the small business environment throughout 2007. These forums are designed to help share important information on the PCAOB inspections process and the effect of new auditing standards. Feedback assists the PCAOB in understanding the unique needs and challenges of the small business community. Although the program will be similar to last year's forums, the PCAOB plans to significantly change it to address emerging issues. In three cities, directors and financial executives of small public companies are invited to participate in a separate event to be held the following day. Upcoming forums will be held in:

- Houston—April 23
- Fort Lauderdale, Fla.—June 1
- San Francisco—June 27, 28*
- Atlanta—Sept. 10, 11*
- New York City—Oct. 22, 23*
- Chicago—Nov. 9
- Washington—December date pending

* Includes second-day event for directors and financial executives of smaller public companies.

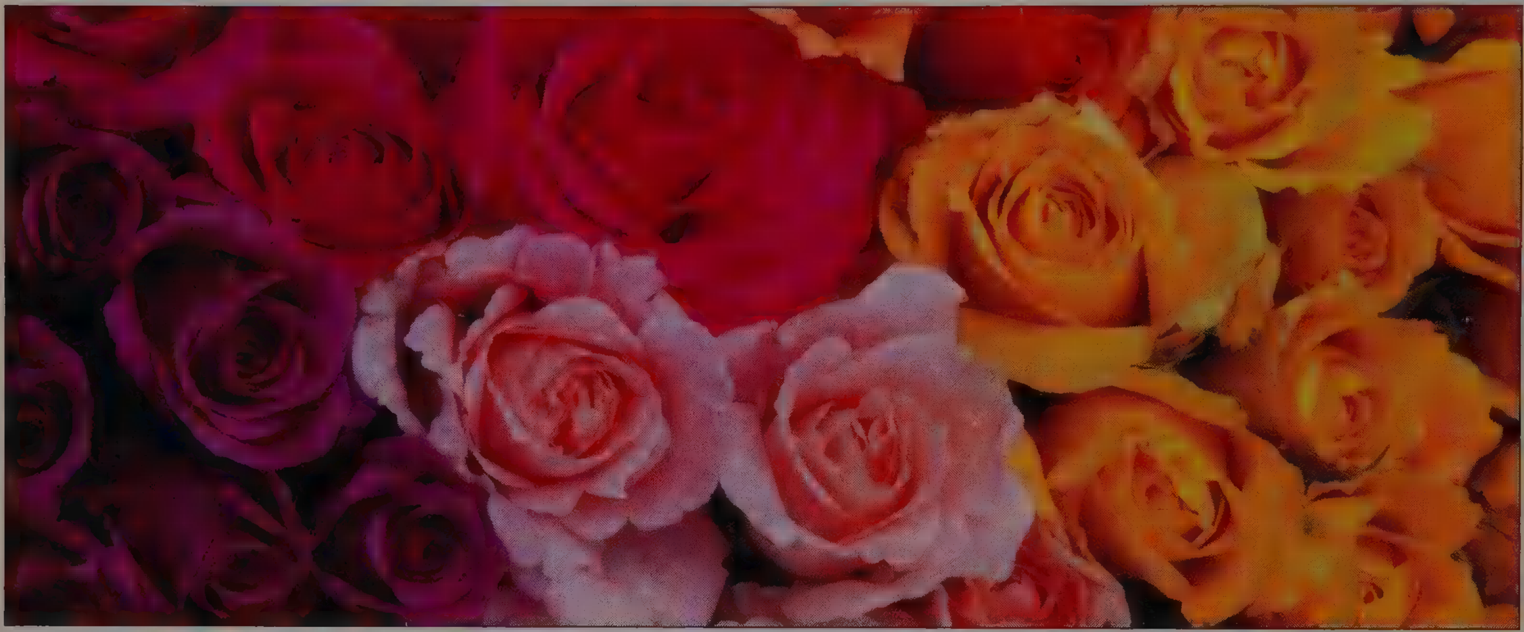
Admission is free; however, preregistration is required. For more information, visit **www.pcaobus.org/About_the_PCAOB/Small_Business/Forum.** For registration questions call 202-207-9061 or e-mail info@pcaobus.org.

topline

News, People, Trends and Other Noteworthy Items

AS QUOTED

"The five most dangerous words in business may be 'Everybody else is doing it.'"
—*Warren Buffett, on stock options backdating*



SURVEY SAVVY

For Love or Money?

It turns out money buys a little bit of happiness, but love conquers all.

In a Gallup survey of 1,010 adults, those who were married, at any income level, were as likely, if not more likely, to report being happy and satisfied than even the wealthiest single adults.

While 72% of respondents with incomes of $75,000 or more reported being very satisfied with their personal lives, only 36% of those with annual incomes of $30,000 or less did. And about 64% of married people said they were satisfied with their personal lives, compared with 43% of singles.

In terms of happiness, 56% of married adults in the lowest income bracket reported being very happy, compared with 50% of unmarried adults in the highest bracket.

Those respondents who had both love and money were happiest of all: 67% of married adults in the highest income group said they were very happy.

Source: The Gallup Poll, **www.galluppoll.com.**

FINANCIAL FUTURES

Red Tide Rising

The next big wave of bankruptcies is on the horizon, say attorneys, financial advisers, investment bankers and other restructuring professionals.

According to a survey by Dow Jones & Co.'s *Daily Bankruptcy Review* and the American Bankruptcy Institute, 82% predicted the next major group of corporate restructurings would hit by the end of 2007.

The majority of the restructuring experts said the industries most likely to be affected are real estate/construction, retail, airlines, manufacturing and transportation.

The most likely trigger: interest rates. Falling home prices, higher commodity prices, global competition and a bear stock market also were expected to contribute.

Source: American Bankruptcy Institute, **www.abiworld.org.**

SURVEY SAVVY

A Matter of Perspective

Fifty may be the new 40 as the nation's 78 million baby boomers approach their 60s, but stereotypes still affect how some managers view older workers, according to an AARP survey.

Executives who managed at least some employees over age 50 rated the workers higher in the following qualities than did executives who managed none in that age group: communication, professionalism, ease to work with, enthusiasm, flexibility, independence, innovation, experience, leadership and technological savvy.

Moreover, the favorable ratings increased with the number of 50-plus workers managed.

All the executives rated older employees high in loyalty, regardless of the number they managed.

Source: *Business Executives' Attitudes Toward the Aging Workforce: Aware But Not Prepared?* 2006, AARP, **http://research.aarp.org.**

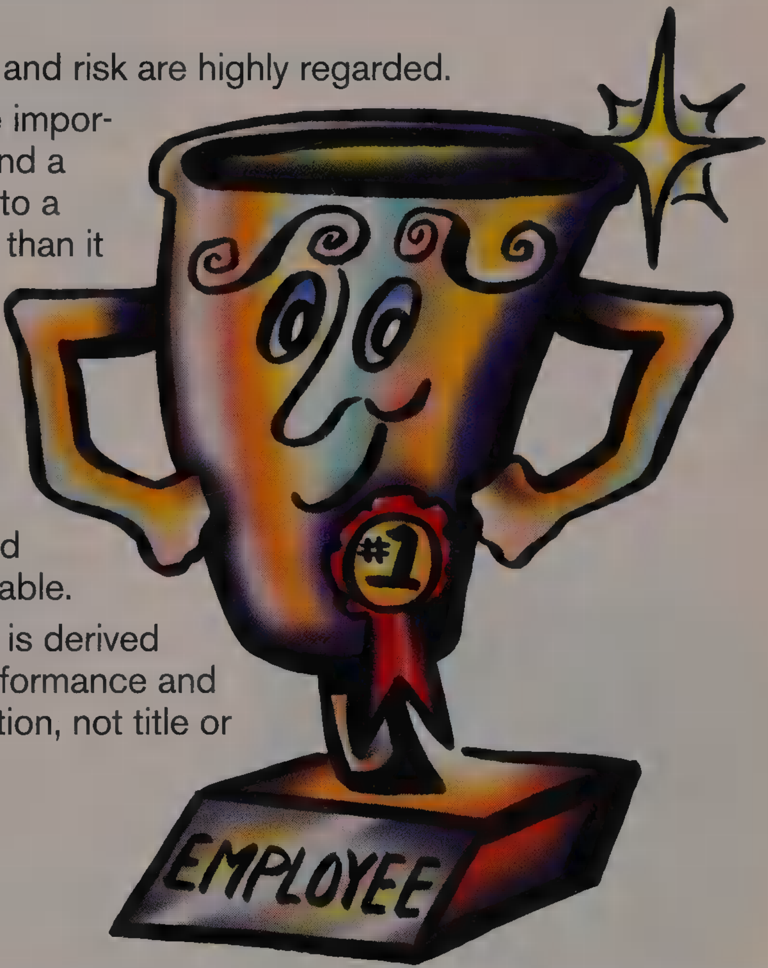
GOLDEN BUSINESS IDEA

Mark of a Good Manager

Call it the trickle-down effect of satisfaction: Happy employees make for happy customers.

Ed Rehkopf, author of *Leadership on the Line—A Guide for Front Line Supervisors, Business Owners and Emerging Leaders*, says an effective manager can motivate workers by creating an environment in which

- Employees are continually recognized.
- An open flow of ideas, opinions and information prevails.
- Initiative and risk are highly regarded.
- It's more important to find a solution to a problem than it is to assign blame.
- Every worker feels energized and valuable.
- Prestige is derived from performance and contribution, not title or position.



BUSINESS TRENDS

Taking Security Into Your Own Hands

More than 80% of companies reported the theft or loss of an electronic data-storage device containing sensitive or confidential information during the previous year, according to a survey by the Ponemon Institute, an information-security research organization, and Vontu, a maker of data-loss prevention software.

The three storage devices most likely to contain unprotected data were PDAs, laptops and USB memory sticks.

Source: **www.vontu.com.**

BUSINESS TRENDS

I'll Raise You One

The average financial professional's salary is more than 30% higher than the national average, according to the 2006 *AFP Compensation Survey*, and is growing at a quicker pace, too. Of the 27 finance-related job positions included in the survey, 25 received salary increases greater than the national average of 3.3%. Base salaries for management level positions increased the most (5.3%). Who's benefiting from the largest bonuses? Financial professionals at the executive level, whose average bonuses were valued at $46,500, or 34% of base salary.

TOP 10

States with the fastest growth rates for majority women-owned firms*

1. Florida
2. Arizona
3. Hawaii
4. Georgia
5. New York
6. Virginia
7. New Hampshire (tie)
7. New Jersey (tie)
9. Rhode Island
10. Nevada

Source: *Women-Owned Businesses in 2006: Trends in the U.S. and 50 States*, Center for Women's Business Research, **www.womensbusinessresearch.org.**
*Firms with at least 51% female ownership.

BUSINESS TRENDS

Most Audit Committees Still Lack Accountants

The number of accountants on audit committees more than doubled from 2002 to 2005, according to Huron Consulting Group's *2006 Audit Committee Research Report* (**www.huronconsultinggroup.com**), which sampled the biographies of committee members at 178 public companies from Nasdaq 100 and *Fortune* 100 listings.

However, more than 60% of the companies still did not have an accountant on their audit committee.

While all companies reported having a committee member with financial expertise, only 23% of those individuals had accounting backgrounds.

DATA POINT

$190,000

The median fraud loss per scheme in 2004-2006 by organizations with fewer than 100 employees. The amount was greater than in even the largest organizations.

Source: *2006 Report to the Nation on Occupational Fraud & Abuse*, Association of Certified Fraud Examiners.

CAREER FRONT

Four Key Indicators Pointing to Promotion

■ Are you READY? Are you a star? Have you developed a reputation in your field? Do you help others in your department? Are you so known for your skills that people look to you for help? Is the next move an obvious career step? If the move doesn't make sense to you, it probably won't make sense to others either.

■ Are you INCLUDED? Are you the type who simply helps out while the choice assignments go to someone else? Or do you get good assignments so you're seen as a person on the leading edge? Are you asked to represent your department on important projects and task forces? Do you volunteer for critical responsibilities, including tasks for which your boss is responsible?

■ Are you ACCEPTABLE to others? Do you get along well with your peers? Do you get along well with your boss? Make sure your boss looks to you for input. Have you supported your boss and never undermined him or her? If not, you're doomed. Have you become part of the power center? Are you known to your boss's peers and others above you? If no one knows your talents or likes you, you won't be promoted.

■ Are you in the RIGHT PLACE at the RIGHT TIME? If you are doing everything right, but your company is not doing well, you're not going anywhere. Is your boss going somewhere? If not, he or she may be a roadblock. Consider lateral moves into faster-growing companies. Think of ideas for changing your present job to move it in the direction you want to go.

SIGN OF THE TIMES

Workers Tune In

Almost one-third (32%) of workers listened to music while working using an iPod, MP3 player or similar gadget, according to a Spherion *Workplace Snapshot* survey. The percentage of workers who felt that listening to a personal music device improved their job satisfaction or productivity was highest among younger adults, with 90% of workers ages 18 to 24 and 89% of those ages 30 to 39 making this claim. In addition, of adult workers who listened to music while working, 55 percent felt it improves both job satisfaction and productivity.

SURVEY SAVVY

Top Five Influences on Business Ethics

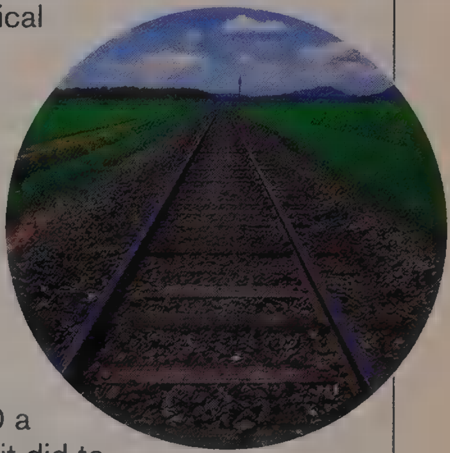
More than 1,100 managers and human-resources experts polled by the Human Resource Institute ranked factors influencing business ethics today and 10 years hence:

Factor	Rank Today	Rank in 10 Years
Corporate scandals	1	4
Marketplace competition	2	2
Demands by investors	3	5
Pressure from customers	4	3
Globalization	5	1

Source: American Management Association/Human Resource Institute, *Business Ethics Survey 2005*, www.amanet.org.

BUSINESS TRENDS

Missing the Train



The typical U.S. company spent nearly 50 times as much to recruit a professional making $100,000 a year than it did to train that person. Across all compensation levels, U.S. companies spent $1,415 in recruiting costs for every $10,000 of new-employee pay. But the median training expense per full-time worker was only $288. Larger companies did worse: Enterprises employing more than 5,000 spent only $109.

Source: Deloitte Research, *It's 2008: Do You Know Where Your Talent Is?* **www.deloitte.com**

Journal of Accountancy News Digest

BANKING

■ Federal bank regulators made an interim decision that FASB Statement no. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, will not affect banking organizations' regulatory capital. Pending further action by the Federal Reserve Board, FDIC, Office of the Comptroller of the Currency and Office of Thrift Supervision, bank holding companies and savings associations should exclude from regulatory capital any amounts recorded in accumulated other comprehensive income (AOCI) resulting from the application of Statement no. 158.

The standard requires organizations that sponsor defined benefit postretirement plans to recognize the overfunded or underfunded status of each such plan as an asset or liability on their balance sheet with corresponding adjustments in AOCI. For additional guidance, visit **www.federalreserve.gov/boarddocs/reportforms/supplemental/SI_FRY9_200612.pdf.**

FINANCIAL REPORTING

■ The SEC adopted an amendment to its executive and director compensation disclosure rules to more closely conform the reporting of stock and option awards to FASB Statement no. 123(R), *Share-Based Payment*. The changes apply to rules the commission adopted in July 2006 to enhance executive compensation disclosure requirements for proxy statements, registration statements and annual reports filed by public companies.

The commission's amendment will align the reporting of equity awards in the Summary Compensation Table and the Director Compensation Table to the amounts that are disclosed in the financial statements under Statement no. 123(R), which requires recognition of the costs of equity awards over the period in which an employee is required to provide services in exchange for the award. The change is intended to give investors a better idea of the compensation earned by an executive or director during a particular reporting period.

The amendment, in the form of interim final rules, was published in the Federal Register on Dec. 29, 2006. The changes apply to proxy, information and registration statements filed on or after Dec. 15, 2006, that are required to include Item 402 disclosure for fiscal years ending on or after Dec. 15, 2006, and for forms 10-K and 10-KSB for fiscal years ending on or after Dec. 15, 2006. The amendment is available at **www.sec.gov/rules/final/2006/33-8765.pdf.**

■ FASB issued for public comment proposed Statement 133 Implementation Issue No. H17, *Foreign Currency Hedges: Hedging Functional-Currency-Equivalent Proceeds to Be Received From a Forecasted*

Cost of Finance Operations Drops

The cost of finance operations in typical companies has dropped since the 2005 spike following Sarbanes-Oxley, but world-class companies have made even more progress.

	2004-2005	2005-2006
Typical Companies	up 18%	down 3%
World-Class Companies	down 5%	down 8%

Source: Hackett Research, **www.thehackettgroup.com.**

Foreign-Currency-Denominated Debt Issuance.

The statement clarifies that the variability in functional-currency-equivalent proceeds expected to be received from the forecasted issuance of debt, denominated in a currency other than the reporting entity's functional currency, cannot be designated as the hedged transaction in a cash flow hedge of foreign currency risk because it does not affect reported earnings, as required by paragraph 29(c) of FASB Statement no. 133, *Accounting for Derivative Instruments and Hedging Activities*. The guidance, if adopted, would apply for each reporting entity on the first day of its first fiscal quarter beginning after the board's cleared guidance is posted on the FASB Web site. The guidance is available at **www.fasb.org/derivatives/12-28-06.pdf.**

■ An AICPA task force and staff produced a working draft of a document designed to guide practitioners in accounting for equity-related financial instruments including convertible debt, convertible preferred shares and warrants.

The document is designed to help preparers and auditors of financial statements determine whether those financial instruments should be classified as stockholders' equity or as assets or liabilities, among other issues. A working draft of the document is available at **www.aicpa.org/Professional +Resources/Accounting+and+Auditing/Accounting+Standards/Working+Draft+of+Convertible+Debt+Convertible+Preferred+Shares+Warrants+and+Other+Equi.htm.**

The AICPA staff also issued technical practice aids answering frequently asked questions on the following topics relating to investment companies:

- Recognition of premium/discount on short positions in fixed-income securities.
- Presentation of reverse repurchase agreements.
- Accounting treatment of offering costs incurred by investment partnerships.
- Meaning of "continually offer interests."

The AICPA staff also issued these TPAs:

- *Income Tax Accounting for Contributions to Certain Nonprofit Scholarship Funding Organizations*, which specifies that a contribution to a scholarship fund eligible for a state corporate income tax credit should be reported on income statements as a contribution, not an income tax expense.
- *Accounting for Certain Liquidated Damages*, which states that liquidated damages, or contractual payments for late or incomplete delivery of certain fixed assets, typically would be recorded as a reduction of payments the buyer has made to the vendor.
- *Parent-Only Financial Statements and Relationship to GAAP* notes a presumption under Accounting Research Bulletin 51 in favor of consolidated financial statements of entities with majority-owned subsidiaries.

These and other recently issued TPAs are available at **www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/recent_tpas.htm.**

GOVERNMENT ACCOUNTING

■ GASB issued an exposure draft of a proposed guidance statement titled *Accounting and Financial Reporting for Intangible Assets* to answer questions about whether and when certain intangibles should be considered capital assets in financial reports. Intangibles frequently encountered by governments include easements, water and timber rights, patents, trademarks and computer software, GASB noted.

Specifically, the proposed statement would require that certain intangible assets be classified as capital assets and addresses issues of identifying, recognizing and amortizing them. Provisions of the proposed guidance generally would be applied retroactively and be reflected in financial statements for periods beginning after June 15, 2009. Comments on the draft, which is available at **www.gasb.org/exp/ed_intangible_assets.pdf**, are requested by March 23.

INTERNATIONAL

■ The International Ethics Standards Board for Accountants (IESBA), an independent standard-setting body of the International Federation of Accountants (IFAC), issued an ED that contains substantive revisions to the independence standards of the IFAC Code of Ethics for Professional Accountants.

The changes:

- Expand the applicability of partner rotation requirements with respect to listed entities and remove the provision that allows flexibility for small firms to apply alternative safeguards.
- Strengthen requirements related to provision of non-assurance services, including setting out additional guidance on the provision of tax services to audit clients.
- Extend the more restrictive listed entity independence requirements to the audits of a wider range of entities of significant public interest.

The AICPA Professional Ethics Executive Committee will be evaluating the proposal and providing comment. Comments are due by April 30. The ED is available at **www.ifac.org/EDs.**

INVESTING

■ In a move intended to enhance the participation of investors and other users of financial information in the standard-setting process, FASB established the Investors Technical Advisory Committee (ITAC).

The committee comprises 12 members from the investment community with strong technical accounting and financial reporting knowledge. The panel will help FASB identify urgent accounting and financial reporting issues, propose new items for the board's agenda and provide perspectives on the standard-setting process.

FASB plans to meet with ITAC in public sessions at least twice each year. Meetings

with FASB staff are expected to occur quarterly.

A complete list of ITAC members is available at **www.fasb.org/news/nr010207.shtml.**

■ The SEC proposed rules designed to provide additional protection to investors in certain pooled investment vehicles including hedge funds. One new rule, under the Investment Advisers Act of 1940 (15 U.S.C. 80b), would clarify the SEC's ability to bring enforcement actions against investment advisers who defraud investors in a pooled investment vehicle. The SEC said the clarification was needed in light of a recent District of Columbia Court of Appeals decision (*Goldstein v. SEC*, 451 F.3d 873), which overturned the 2004 "Hedge Fund Rule" on SEC registration requirements for funds.

Two more new rules would revise requirements under the Securities Act of 1933 (15 U.S.C. 77) for determining an individual's eligibility to invest in pooled vehicles. The definition of *accredited investor*, as the term is applied by some privately offered investment pools, may not provide sufficient protection to investors, the SEC said. The proposed rules are available at **www.sec.gov/rules/proposed.shtml**, which also has a link for submitting comments by March 9.

MONEY LAUNDERING

■ The Treasury Department needs to improve its enforcement of laws to detect and deter criminal financial activities, the GAO said in a report to Congress. Thirty-six years after passage of the Bank Secrecy Act (BSA), Treasury's Financial Crimes Enforcement Network (FinCEN) and the IRS still face challenges in fulfilling the law's mandates, the GAO said. The IRS has not identified and examined all nonbank financial institutions (NBFIs) such as check-cashing and money-transmitting businesses, as required under BSA, the GAO said. And FinCEN was unable to complete a planned data system despite spending $14 million on the project—$6 million over its original budget, the GAO said. FinCEN also lacked a comprehensive plan for taking over BSA data management from the IRS, according to the report.

FinCEN regulations defining NBFIs are confusing, making it harder for the IRS to identify them, the GAO said. But the IRS has not developed a statistically valid, risk-based method of selecting NBFIs for examination from among those it has identified, the GAO said. The report recommends the agencies develop a strategy to clarify rules, strengthen data management and better coordinate their activities.

The BSA, also known as the Currency and Foreign Transactions Reporting Act, was enacted to prevent banks and other financial service providers from being unwitting intermediaries in the concealment, transfer or deposit of money deriving from criminal activity.

■ FinCEN and the SEC announced an agreement for the routine exchange of examination and enforcement information aimed at identifying, deterring and interdicting terrorist financing and money laundering. The agreement is intended to improve monitoring of SEC-regulated firms' compliance with the BSA and identify institutions with BSA violations or deficiencies.

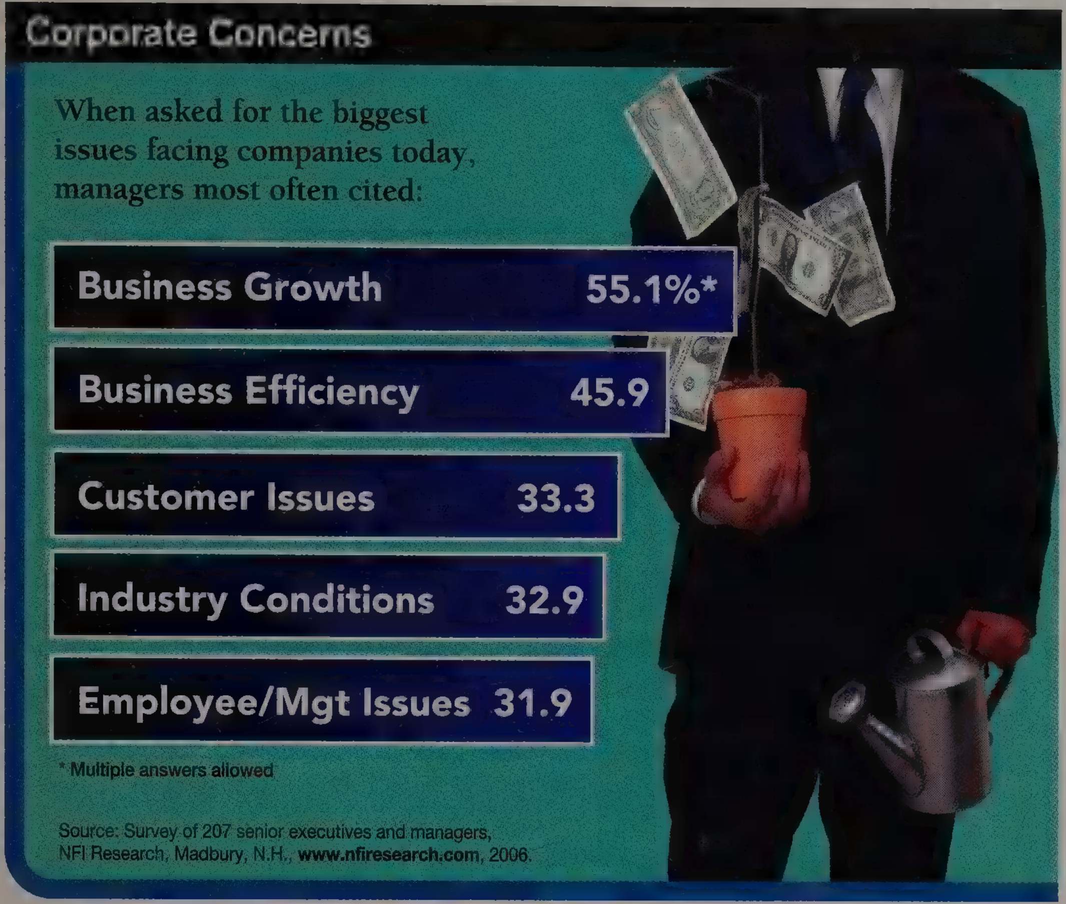
The pact calls for the SEC to provide FinCEN quarterly with detailed information about anti-money-laundering examination and enforcement activities. The commission and FinCEN will meet regularly to continue efforts to improve anti-money-laundering and anti-terrorist-financing compliance.

■ FinCEN and federal banking agencies revised the format for the Suspicious Activity Report by Depository Institutions (SAR-DI) to support a new joint filing initiative, which will reduce the number of duplicate SARs filed for a single suspicious transaction. Filers may begin using the new format June 30, 2007; they will be required to file in the new format by Dec. 31, 2007.

Happy to Stay Put

As of September 2006, 65% of American workers were confident in their current employers' future and 79% were secure in continued employment with their present company.

Source: *The Spherion Employee Confidence Index*, monthly survey of 3,071 U.S. employees, Spherion, Fort Lauderdale, Fla., **www.spherion.com**, 2006.



Financial institutions can review and download the PC fill-in version from FinCEN's Web site at **www.fincen.gov** under "What's New."

TAX FILING

Many more corporations now must file their tax returns electronically, and the AICPA offers an online informational aid to help CPAs meet their corporate clients' e-filing requirements. Corporations with total assets of $10 million or more that file at least 250 returns annually, such as W-2s or other employment tax forms, are required to e-file their forms 1120 or 1120S for tax years ending on or after Dec. 31, 2006. In the previous filing season, the threshold was $50 million. The AICPA guide, in Microsoft PowerPoint format, is available at **http://tax.aicpa.org/Resources/Corporations+and+Shareholders/AICPA+PowerPoint+on+IRS+Mandatory+Corporate+E-File+Program.htm**. The IRS also offers corporate e-filing information and resources at **www.irs.gov/businesses/corporations/article/0,,id=146959,00.html**.

DEALS & DEVELOPMENTS

The Big Four firms announced 2006 results ranging from 9.6% to 11.5% growth worldwide. Combined, Big Four revenues totaled $77.3 billion.

Twenty-two midsize firms joined a new alliance called Baker Tilly USA (a new branch of network Baker Tilly International) in an effort to compete with larger firms for U.S. audit business.

Meanwhile, China announced plans to develop its own international accounting firms. The policy statement by the Chinese Institute of Certified Public Accountants (CICPA), which was first reported by the *Financial Times* in October, says that in the next five to 10 years China should develop 10 accountancy firms capable of operating internationally. The firms would audit foreign operations of Chinese companies that are currently being audited by Big Four firms. ❖

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New Resources

Publications...

Independence Compliance: Checklists and Tools for Complying with AICPA and GAO Independence Requirements

This handy practice aid is a useful tool for anyone performing an audit engagement. A series of questions helps identify potential independence issues. Suggested follow up items are then presented that auditors may consider in addressing an independence issue.

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Housing Market Slowdown Spells Savvy CIRA Audits

New Audit Risk Alert Covers Industry Developments in Common Interest Realty Associationss

by Lori West, CPA

Adapted from "Common Interest Realty Associations Industry Developments 2006/2007 – Audit Risk Alert" (No.022467, www.cpazbiz.com or toll-free 1-888-777-7077)

Today, 85 percent to 90 percent of all new for-sale housing is located in one of the three basic types of community associations. Somewhere between 40 percent and 60 percent of common interest realty associations are contract managed by specialized community association management companies while the other 40 percent to 60 percent are self-managed either solely by volunteers or with association-hired staff. Regardless of management structure, all associations are governed by a volunteer board of directors elected by the membership.

When planning an audit the auditor of a CIRA should assess, among other things, the board members' level of experience or whether there is a small group of homeowners who control the CIRA and have done so for years. These boards, for instance, supervise the collection of over $41 billion in annual assessments and maintain investment accounts of another $36 billion to $37 billion for the long-term maintenance and replacement of commonly held property.

Housing prices showed annualized double-digit gains for the last three years. Due to these increases in real estate prices, most accountants have seen minimal bad debt write-offs as there has been "built in" equity in a unit, even just a few months after the purchase of a unit, due to the economy.

Thus, if the association has been diligent in its collection measures and has filed liens and foreclosures, they have been able to collect the past due assessments, fees, and charges. But most housing markets in many areas of the country are now seeing a leveling off, or at the most a slight increase or slight decrease, in housing prices. Predictions are for this flattening off to continue through 2007.

Added to this issue is the fact that there has been an increase in adjustable rate and nonconforming mortgages used by owners to purchase their homes. In the climate of increased interest rates, as those loan payments are adjusted to the current rates, some homeowners will find payment of the monthly mortgage payment difficult. Roughly $137.5 billion in residential mortgages will face payment resets in 2006 and another $524 billion will reset in the next four years (according to an analysis by the Union Bank of Switzerland, UBS AG). These loans are found in all income brackets.

With the softening of the housing market in some areas, and the increased home mortgage payments, it is probable that write-off of assessments to bad debt will increase in the future. It is the auditor's job to determine whether management's estimate of the allowance for bad debts is reasonable.

As the residential real estate market continues to cool, auditors of CIRAs must be conscious of these and other financial impacts a cooldown may have on the CIRA's financial situation.

Smart Stops on the Web

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This Smart Stop offers plenty of resources to get your small business clients off to a good start. Check out the Financing a Business area for tips on controlling taxes and cash flow or read about the five basic rules of Internet marketing. See a glossary of business terms and free sample business plans. The site also has links to about 40 blog directories, which can help clients reach a wider market for their Web content.

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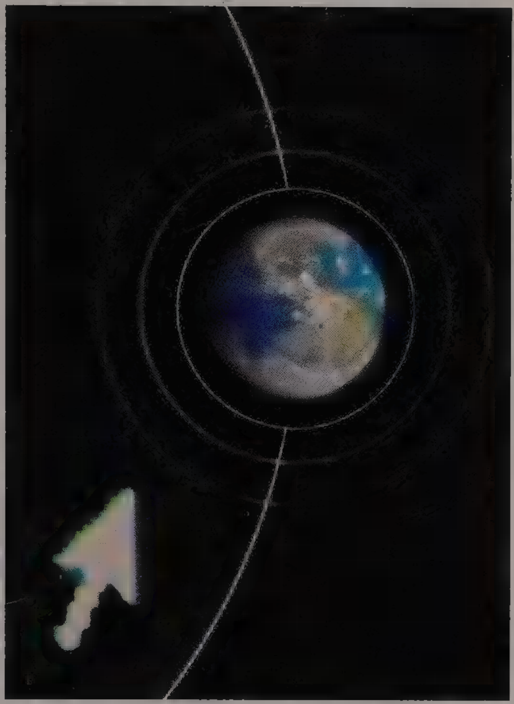

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GENERAL INTEREST SITES

THE HIGH ROAD
http://ethics.iit.edu
Professionals interested in staying on the straight and narrow can find guidance at the Illinois Institute of Technology's online Center for the Study of Ethics in the Professions. Research how to write a code of ethics for your firm, find links to user guides and read actual codes of ethics from various industries including communications, finance, law and management. Get case studies on business and finance ethics, as well as sample cases used in the 12th annual Intercollegiate Ethics Bowl.

TUITION TUTORIALS
www.salliemae.com
Personal financial planners will want to bookmark this Smart Stop for clients with children looking to pay college tuition. Find tips on saving for school, understanding costs and assessing financial need, as well as links to applications and checklists for loan programs. Find tools to estimate monthly payments and calculate savings. Also read Sallie Mae's *How to Pay for College: A Practical Guide for Families.*

WIT AND WISDOM
www.taxtwist.com
Enrolled agent Eva Rosenberg's Web site offers visitors a break from the usual tax rules and regulations with humorous anecdotes—the credit card company that kept billing a deceased customer for annual service charges—and inspirational tales such as the one about 9/11 victims. Also get a tax calendar with annual deadlines and a link to her other site, www.taxmama.com.

FOR THE JET SET
www.businesstravel.com
Find out how to deal with flight delays and remove stains from your favorite suit, all on the same site. You can read articles aimed at frequent flyers or book flights, rental cars and hotel rooms. Click to find business-info links, travel resources such as currency converters, and a list of foreign tourism bureaus.

HERE'S TO YOUR HEALTH
www.mayoclinic.com/health/working-life/WL99999
The Working Life section of the Mayo Clinic's Web site offers plenty of advice to cure what ails you at the office. For example, the tips for maintaining work-life balance can help if you're returning from maternity leave or have a sick child at home. You can also read articles that provide solutions to work-induced problems such as eye strain, stress and burnout. The On the Job link leads to a page of tools and topics that can help you make your career more rewarding or bridge the generation gap among employees.

—Vince Nolan and Amelia Rasmus

School Your Clients to Stop Theft

Maybe it's only human nature, but all too often businesses stung by embezzlement first blame their outside CPA instead of assessing controls of their own that might have prevented the theft in the first place. These suggestions can help you teach small to midsize businesses and nonprofit clients how to be more vigilant.

❑ ***Conduct background checks on prospective personnel.*** Thoroughly check references and scrutinize all dates and time gaps in resumes. Have employees bonded if they have access to cash or work in financial functions.

❑ ***Send bank and credit card statements straight to the top.*** The company's owner, manager or a nonprofit audit committee member should be the first to review all bank account entries and canceled checks. Someone without authority to issue checks should reconcile bank statements and review them for forged or altered checks. Before paying credit card bills, support each charge with an original receipt.

❑ ***Review documentation for all check requests.*** Compare original vendor invoices, purchase orders and receiving reports for agreement on quantities, brands, product descriptions and services requested. All should be stamped "paid" and marked with the related check number.

❑ ***Monitor cash receipts and deposits independently of employees recording them.*** Have someone not involved in making deposits or recording accounts receivable open the mail, count money received and report totals to the owner-manager or other official who compares the reported amount to the amount deposited.

❑ ***Reconcile accounts receivable and accounts payable monthly.*** Have the owner, manager or nonprofit audit committee member review and clear all exceptions.

❑ ***Check out first-time vendors.*** Someone independent of buying and payment processing should review all entries for new suppliers. That person should call to verify the supplier's name, address and federal tax identification number.

❑ ***Restrict authorization and access to finances.*** Ensure that only appropriate employees can make transactions or have access to assets, documents and records. Password-protect computer files and set dollar limits on check authorization. Other safeguards include dual custody of cash receipts or cash on hand and ensuring cash and financial documents are secure.

❑ ***Make employees take vacations.*** Especially require personnel in accounting, human resources and cash-handling functions to take one to two weeks off each year, preferably at the end of an accounting cycle. Cross-train employees so that someone else can do their job—and double-check their work—during the vacation.

❑ ***Watch for red flags in employee behavior.*** They can include substance abuse, gambling, change in lifestyle, extramarital affairs, living beyond one's means, possessiveness of work, high personal debts, high medical bills, peer pressures or simply dissatisfaction with work.

Source: Leon A. LaRosa Jr., CPA, is managing partner and chairman of litigation support services at Gocial Gerstein LLC in Jenkintown, Pa. He also is an adjunct professor and director of The Institute of Fraud and Forensic Accounting at La Salle University in Philadelphia. His e-mail address is llarosa@gocialgerstein.com.

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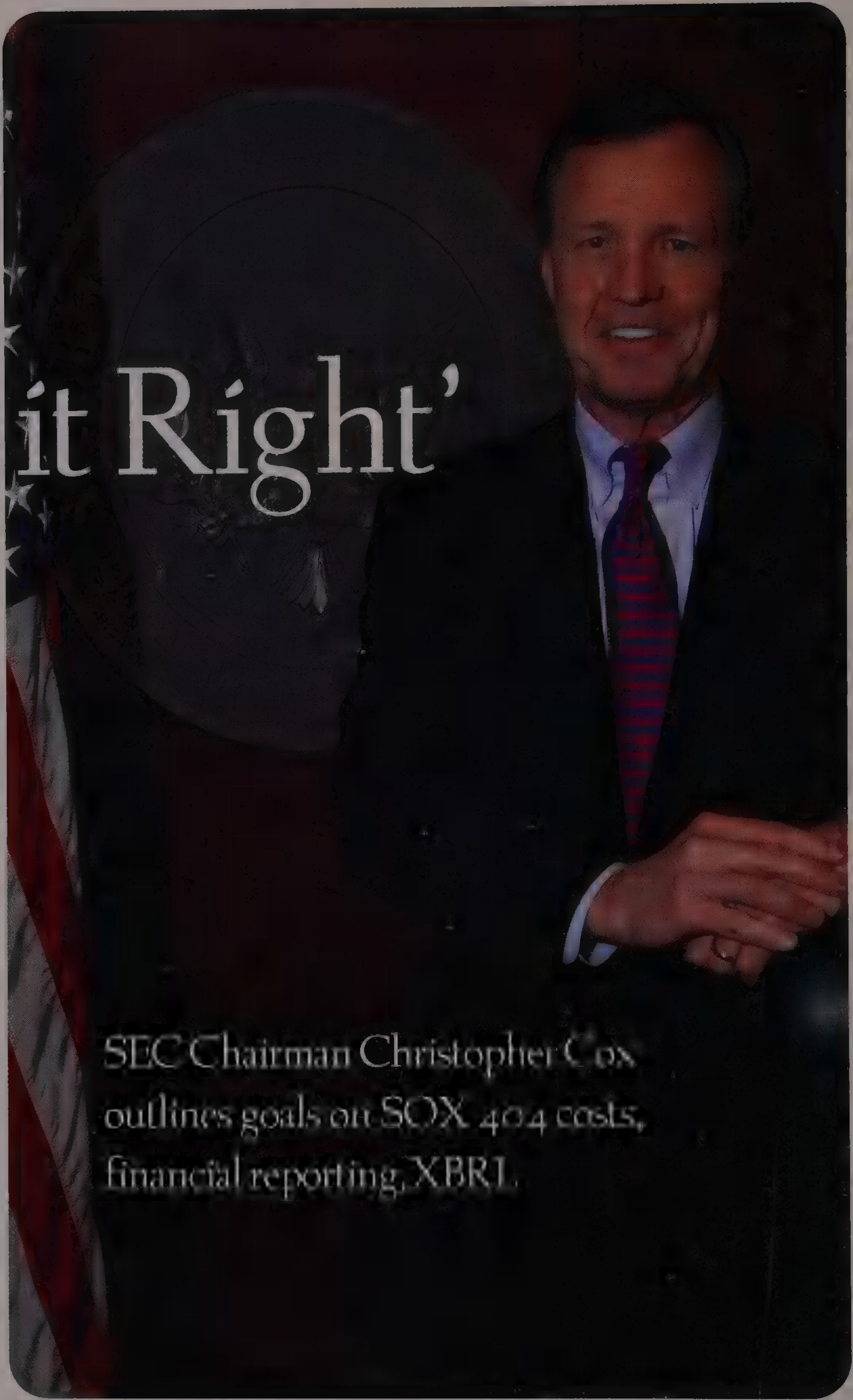
'Getting it Right'



SEC Chairman Christopher Cox outlines goals on SOX 404 costs, financial reporting, XBRL

Since being sworn in as the 28th SEC chairman in August 2005, Christopher Cox has pursued an ambitious agenda of trying to protect the investing public while making government regulation more tolerable for industry. Cox served in Congress from 1989 to 2005, including terms as chair of the House Policy Committee, the Committee on Homeland Security, the Select Committee on U.S. National Security, the Task Force on Capital Markets and the Task Force on Budget Process Reform. Chairman Cox spoke recently to *Journal of Accountancy* Publishing Director Geoffrey Pickard about issues facing the SEC and the CPA profession.

JofA: *The SEC and the PCAOB in December issued proposals on changes to the implementation of [Sarbanes-Oxley] section 404. What do you hope to achieve and what outcome do you see?*

Cox: We are absolutely committed to wringing out the unnecessary costs of section 404. As a member of the House-Senate Conference Committee that wrote the final law, I can say with some authority that Congress never intended for section 404 to be unduly burdensome and expensive. It came as a surprise that legislative language that had been copied virtually word for word from the FDIC Improvement Act, where it had not

ruffled any feathers, was the source of multimillion-dollar expenses for companies of all sizes.

I expect that 404 relief will be in effect for companies both in the United States and abroad no later than the second quarter of 2007.

JofA: *Many of our members are auditors or members of management in companies that have decided to list on the Alternative Investment Market of the London Stock Exchange. We've been told that AIM came about for many reasons, including lower costs, because companies listed there do not have to comply with SOX regulations. What effect do you believe SOX has had on the overall competitiveness of U.S. markets?*

Cox: Certainly, the early implementation costs of Sarbanes-Oxley, particularly section 404, caused many people in America to at least take a look at opportunities overseas. But even as we are taking aggressive steps to reduce the cost of Sarbanes-Oxley implementation, we're also now noticing that the flirtation with other overseas markets is abating. There never really was a rush of American companies listing on AIM and other similar venues. That's because the depth of those smaller specialty markets is not the same as in the United States and the price support for issues in the after-market is not as strong as companies would like. So there may well be opportunities for U.S. exchanges to build these niches. In fact, the American Stock Exchange has expressed some interest in doing this.

JofA: *Some believe that non-U.S. exchanges and markets have used SOX and regulation as a competitive tool. Are U.S. markets less attractive today, do you think?*

Cox: No, but they are facing increasing competition. There now are substantial pools of capital to be tapped in a number of markets around the world, and the United States is not the only place that companies can list. But the United States still has substantial advantages, and they are evident in the relative market share of America vs. the rest of the world.

From a regulatory standpoint, our job is to make sure the only risk investors face is the inherent risk of the companies in which they invest, and not the risk of fraud, unfair dealing or erroneous information. To the extent that we are successful in that mission, U.S. markets will have a competitive advantage.

JofA: *Some believe Sarbanes-Oxley has created an environment where management is reluctant to seek advice from its auditors on complex accounting and business transactions for fear of creating an independence issue. But auditor advice often can enhance financial reporting. What are your thoughts on this?*

Cox: I believe strongly, and the commission believes strongly, that there is value in companies consulting with their auditors. The SEC will continue to do whatever we can to ensure the benefits of auditor involvement are retained as we enforce our rules concerning auditor independence.

JofA: *There is a growing market concern over the increasing complexity of financial reporting. What are the SEC's plans to address the issue domestically and internationally, and what can the AICPA, and the accounting profession as a whole, do to help?*

Cox: The accounting profession is actually leading the charge in the war on complexity that the SEC has joined. The reasons for battling the growing complexity in the accounting literature and in the practice are simple: If the rules become a thicket in which fraudsters can hide instead of a means to achieve truth, then we can't achieve our goal of protecting investors.

The FASB and the SEC are working together to codify all the accounting literature, and the FASB is focused on particular subject areas that are notoriously complex, such as leases and intellectual property and pensions. The practitioners who have to deal with this complexity are in the best position to help us get it right. I see the profession playing a leading role here.

As a member of the Financial Services Committee and the Energy and Commerce Committee in the Congress, I participated in extensive hearings on the Enron scandal. Enron was the paradigm of complex

error covering up simple truth. It taught us anew that complexity can be the enemy when it comes to investor protection.

JofA: *XBRL is revolutionizing the efficiency of the reporting process and the usability of reported information. Your recent initiatives support this concept, but there's more to be done in terms of providing more reliable and relevant information for the investor community. How do you believe the content of reported information should be enhanced to better serve user needs and capital market efficiency? What will the commission do to encourage the business community to report on this information?*

Cox: XBRL is a tool, a way for us to use financial information in the same way we use almost every other kind of information today on the Internet. We at the SEC are aggressively embracing this new opportunity, both internally in our own business processes and with respect to registrants.

The SEC is concerned with making disclosure more useful for investors. That's the whole point of our focus on using interactive data for financial reporting. Enlisting the power of new technology in our efforts to improve the usability of financial reporting is a natural.

Everything about our lives is more real-time today than it was a decade, or even five years, ago. The same is certainly true for financial reporting. There are simply more means available now to find out what's going on in the marketplace than there ever have been before.

We already put American companies to a fair amount of expense to prepare the financial disclosures that the SEC demands. Now we intend to make that effort more worthwhile by ensuring that it results in something useful for investors. Through technology, we can simultaneously reduce the cost of providing the information and make it more useful for the customer.

JofA: *The SEC has awarded a contract to XBRL US Inc. for the creation of financial reporting taxonomies. Do you envision XBRL US as the coordinator of taxonomy development for the non-financial elements of the 10-K, such as the MD&A, proxy statements and so on? What about reporting for other agencies, such as the IRS, OSHA, EPA and so forth?*

Cox: The mission of XBRL US and, indeed, of XBRL International is much broader than merely financial reporting. The genius of what I call interactive data is that the computer standards are open source and market driven. This is not a government enterprise; it is, in every way, a private-sector enterprise. By its very nature, XBRL can be used to tag data of all kinds, both numbers and text. So if you've got a complicated mixture of text and numbers in a government report to the Environmental Protection Agency, for example, there's no reason in the world it couldn't be produced in XBRL format, for the benefit of both the provider and the government agency.

JofA: *How about the European Commission? What is its level of receptivity to XBRL?*

Cox: The international effort also has been private-sector and market driven. The government agencies aren't always in the forefront. Some, such as Her Majesty's Customs and Revenue in the United Kingdom, have been quick to seize the opportunities. That agency has made the XBRL format mandatory for reporting by companies. But in other agencies the government attitude toward XBRL is wait-and-see. It is because the commercial benefits are so strong that the international private-sector effort has long been under way, and governments from the European Commission to the United States are piggybacking on the effort.

JofA: *How do you see the AICPA's role regarding XBRL?*

Cox: AICPA was there at the founding. Back in 1998, the AICPA was part of the working group that launched XBRL in the United States, and it's still in the forefront today. The AICPA is very energetically involved in what is now a much more mature effort.

JofA: *How is the SEC incorporating XBRL into your own business? I know EDGAR must be a potential beneficiary.*

Cox: We're incorporating it in two ways. First, what I call "interactive data" is going to be a hallmark of our much-improved and qualitatively superior disclosure for ordinary investors. Second, with respect to the SEC's internal work in the areas of corporation finance, market regulation, investment management, examinations and enforcement, and accounting, interactive data is going to help us do a much better job of analyzing the massive amounts of information that are filed with the commission.

In that respect, by the way, the SEC is not unique. Anyone who analyzes data is going to find XBRL to be a time-saving tool, including, most obviously, professional analysts of securities. If as an analyst today I can track 100 companies, tomorrow, with XBRL, I will be able to track perhaps 200, because the data will be in a much more accessible and useful format.

"It's just as difficult to do this job as a regulator as it was to write the legislation in the first place."

Every day brings new opportunities to improve people's access to information, especially in the area of financial reporting. The SEC is doing everything we can to capitalize on available technological opportunities and convert what for decades have been paper-based forms into searchable data that can be immediately downloaded into spreadsheets or other financial software and used by our customers in more productive ways.

Over the coming decades, financial information almost certainly will be available in nearly real time and delivered to people in what today would be considered unusual ways—for example, streamed to them in already-processed form over wireless devices they carry in their hip pockets.

There's no limit to the possibilities. Our era, appropriately called the "Information Age," is a golden age for markets.

JofA: And information is power.
Cox: More-efficient markets mean a lower cost of capital, which in turn translates into more productivity throughout our economy—so customers and consumers are better off.

JofA: There has been talk at the SEC recently of encouraging real-time reporting—for example, by eliminating quarterly reviews and certain auditor responsibilities. How do you envision this all working?
Cox: The SEC has not, in any formal way, proposed abandoning our periodic reporting model. But, as a gloss on the periodic reporting model, it's easy to imagine that providing investors with more real-time and more qualitative, as opposed to merely numerical, information could offer significant benefits. The leaders of the Big Four accounting firms recently published on this topic, and they see great promise here.

JofA: Let's spend a minute on the current fraud auditing standard. Do you agree with those who say it's broken?
Cox: As you know, the PCAOB has adopted SAS 99, which was originally promulgated by the AICPA. It's now up to the PCAOB to determine whether its application is working as intended. To that end, the PCAOB has been having some considerable discussion with its advisory groups focused on the fraud standard. The SEC looks forward to reviewing any recommendations the PCAOB makes in this area or any amendments it suggests to the standard.

JofA: What are your expectations for the convergence of the PCAOB and IAASB auditing standards?
Cox: It's absolutely essential that we share best practices around the globe, because, increasingly, investors in every country are relying on the financial reports of issuers in many other countries. The capital markets are shrinking fast, and both auditing and accounting standards that for so long have been maintained on a national basis are now bumping into each other. This is an ongoing dialogue with regulators and private-sector organizations around the world. The easier question is whether convergence will come about; in one form or another, it will. The difficult part is precisely how that happens. I believe that technology—in particular, interactive data, which could be developed to render a given data set in any accounting system one chooses—offers great promise.

PHOTOGRAPHS BY BILL PETROS/MATTOX PHOTOGRAPHY

JofA: In your own career you moved from being a member of Congress to being a regulator. Are you enjoying this new role? What are some of the joys and frustrations?
Cox: Well, it certainly is interesting to be given the responsibility to write regulations under laws that I wrote as a member of Congress. We recently completed very extensive negotiations with the banking regulators that resulted in a joint rule proposal under the Gramm-Leach-Bliley Act of 1999, for example, and I was on the House-Senate Conference Committee for that legislation. The fact that it had taken the agency since the late 20th century to adopt rules under Gramm-Leach-Bliley is a measure of how difficult the job was. I think my insight as one of the authors of the legislation helped somewhat, but I also learned something: When Congress reaches political compromises (in this case, with the securities and the banking industries) with the expectation that the professional regulators will work out the details, it is assuming a great deal. There is no magic wand that regulators can wave. It's just as difficult to do this job as a regulator as it was to write the legislation in the first place.

I've also had the opportunity to work on the implementation of Sarbanes-Oxley—where again there was a significant difference between our expectations in writing the law and what happened after it was passed. So there's been some satisfaction in being able to finish the job of getting it right.

Time and again, I've seen how the effects of legislation enacted by Congress, both intended and unintended, play out in the regulatory sphere. It's been eye-opening and challenging. But it's also been most enjoyable. ❖

Help Clients Get Government Contracts

Quick, who is the biggest customer in the world?

by H. Charles Sparks and Henry Wichmann

Big Opportunities

Of the more than $314 billion in federal contracts awarded in FY2005, about 25 percent (nearly $80 billion) went to small businesses.

Source: Small Business Goaling Report, Federal Procurement Data System, **www.sba.gov/GC/goals/SmallBusinessGoalingReport_2005.pdf**

It's the U.S. government, of course. CPAs in public practice who take the time to understand the federal procurement process can help clients tap into this enormous buyer of goods and services.

Helping clients compete successfully for a share of government business adds value to your firm's services, facilitates cross-selling and increases revenue. Learning procurement protocol and developing relationships to better navigate this highly regulated marketplace can benefit your employer, too. This article provides an overview of the federal procurement system and suggests strategies for acquiring the expertise you need to steer interested parties through the registration process.

Qualification Requirements

Like any large entity, the federal government requires vendors to prequalify. An excellent reference guide for this process is the *Central Contractor Registration Handbook*, which is available at **www.ccr.gov/handbook.asp**. The book explains the process in detail and provides all the necessary links that support registration, including authoritative federal acquisition regulation (FAR) information. Each branch of the military has a version of FAR. For an example, the Air Force's FAR is at **http://farsite.hill.af.mil/**. It is easier to register if you first do some research on government requirements.

There are several preconditions to registration: obtaining a data universal number (DUNS), knowing the client's product and service codes, and having the requisite business and other required licenses. Clients can obtain a DUNS free from D&B (**www.dnb.com/ccr/register.html**). This nine-character number uniquely identifies your client's business.

Next determine your client's industrial classification code under the North American Industry Classification System

(NAICS); it will identify your client's products within the federal procurement database. It is essential to be familiar with NAICS so that you properly classify goods and services within the database of federal contractors. Refer to this Web site for information and guidance about the process: **www.census.gov/epcd/www/naics.html**.

Qualifying as a small business or other preferential seller brings significant advantages. Each federal agency has individual targets for small business purchases—and these often are allocated regionally. To take maximum advantage of these targets, your clients will need to meet the program eligibility criteria for small business in the appropriate NAICS classification for the goods or services solicited. It is possible to register in multiple industry classifications and independently meet the small business criteria in one or more of them.

Registering Clients

Now you're ready to register with the Central Contractor Registration Web site (**www.ccr.gov**), the gateway for doing business with the federal government. Registration gives companies visibility and shows their readiness to do business. You'll be required to enter descriptive information about your client, including ownership, a point of contact, banking information, tax ID and summary financial information for the past three years, if available, and whether it is eligible for small business programs or other special programs. All information provided is subject to verification and is made available to federal agencies and their contracting personnel.

It's especially important to properly identify and register smaller businesses that may be eligible for special programs and set-asides—that is, special contracting award targets. Small business designation criteria vary by industry classification. In some industries classification depends on the number of employees; in others it depends on the average revenue over the past three years.

> The federal government... encourages vendors to submit solicitations, proposals, bids, quotes, awards, invoicing and payments electronically.

The Commerce Department annually reviews and changes thresholds for small business status. Qualifying as a small business entity can bring significant advantages. Clients also can register multiple business lines, some of which might meet the small business criteria. A registrant's classification is determined automatically based on information provided with CCR registration. Registration information must be updated at least annually—and it must be accurate. Small business or other preferential contractor status is subject to challenge by competitors, and errors can result in denial of contract awards.

It is worthwhile for your small business clients to contact the local Small Business Administration (SBA) office as well. It plays an important advocacy role for small businesses and puts valuable resources at their disposal. The Procurement Technical Assistance Center (PTAC) also is a good stop to identify opportunities for smaller businesses. This quasi-government organization is very knowledgeable about government procurement systems at both the federal and state levels. These offices vary regionally—

General Services Administration (GSA) contracts

GSA contracts can be a great source of business for CPA clients or employers. Direct purchases using federal government purchase cards (GPC) do not follow the standard procurement process, and buyers have incentives to locate and use GSA contract holders. In becoming a GSA contract holder, a business must commit to provide goods or services at a specified rate for a fixed period of time and to link to the GSA Web site. Sales are generated largely through direct-marketing channels such as Yellow Pages listings, Internet searches, trade fairs and advertisements.

EXECUTIVE SUMMARY

- **The U.S. government is the biggest buyer** in the world. CPAs can help clients build business by learning the federal procurement process and advising on how to compete successfully for a share of government business.
- **Companies first must obtain a data universal number** (DUNS) from D&B, know the appropriate government product and service codes and have all required licenses.
- **The federal government requires vendors** to prequalify. The *Central Contractor Registration Handbook* (**www.ccr.gov/handbook.asp**) is an excellent reference guide for the process and provides all the necessary links.
- **The Central Contractor Registration Web site** (**www.ccr.gov**) is a gateway for doing business with the federal government. Registering with it shows that businesses are prepared and provides them with visibility.
- **Registration information must be accurate** and it must be updated at least annually to be eligible for special programs and set-asides.
- **The federal government has embraced** paperless/e-commerce technology in a big way. It highly encourages companies to provide all solicitations, proposals, bids, quotes, awards, invoicing and payments electronically. A client who does not currently have this capability is a candidate for an additional service.

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some states have many while others have none. The SBA Web site (**www.sba.gov**) lists SBA and PTAC offices.

Note that the federal government has embraced technology in a big way. It highly encourages vendors to submit all solicitations, proposals, bids, quotes, awards, invoicing and payments electronically. If your client does not currently have this capability, this is another service opportunity you can offer.

Once registered, your client is ready to find out who is buying what. We'll discuss several ways to locate business opportunities after we review the solicitation and awards process. Most solicitations for more than $25,000 are posted on the Federal Business Opportunities (**www.fbo.gov**) Web site.

Reach Out

Get your client out into the field to meet contracting officers and possibly give "capabilities briefings." The PTAC also can help you identify local contracting offices and key staff. It is a good idea to contact them directly to introduce your client(s) and discuss opportunities. Every federal agency whose contracting office makes annual awards in excess of $100 million has a designated full-time small business specialist whose job it is to fulfill purchase "targets" for that agency. Agencies that spend less than $100 million annually will not have a dedicated staff member but will have someone designated to fulfill targets. Following up with those agencies is important to keep your client from falling through the cracks.

The next step is to submit a proposal to provide the goods or services. You must work through several important considerations with your clients. First, the federal government has moved away from "lowest price" criteria to "best value." You must impress upon your clients how important it is to study the solicitation and identify the criteria (for example, past performance, experience or price) being used to rate proposals.

Each solicitation will identify the NAICS classification based on the type of goods or services requested. It is possible to challenge the NAICS classification of a particular solicitation, but you must do this prior to a contract's award. Often, selection of the NAICS classification is done by the soliciting agency's local contracting officer. That individual may buy goods and services across the entire spectrum, and errors are possible. Challenges must be timely and must follow specific rules outlined in the appropriate FAR.

The requesting agency's contracting officer will review the proposals received in response to each solicitation and make a formal award. If your client is chosen, it is important to perform satisfactorily to receive future business. The government maintains a blacklist of companies and individuals on the CCR Web site that contracting officers are required to search before making an award.

As mentioned, the federal government has implemented a paperless contracting process that requires electronic invoicing and payments. Invoicing requirements are specified on the Wide Area Work Flow (WAWF) information page (**www.dod.mil/dfas/contractorpay/electroniccommerce/wideareaworkflow.html**). Payments will be delayed if documentation is incomplete or late. Payments will go to the bank account identified in CCR registration, though this can be changed easily.

A Small Advantage

One strategy for success in seeking federal contract awards is to play the "small business card." Significant benefits are available for clients who qualify as small businesses or as minority, veteran or disabled businesses. All federal agencies are allocated targets to encourage them to award contracts to small or preferred businesses. The allocations are established every Oct. 1, the first day of the federal fiscal year, and your clients can request the information from local contracting offices.

Your small business clients also can take advantage of PTAC resources that help them promote and network in federal and state procurement systems. Those offices are staffed by knowledgeable people who can identify needs and assist businesses in proposing solicitations. They meet regularly with federal and state contracting officers in their region and can help businesses become more visible and connect with the right people.

Not all federal purchases occur through the traditional solicitation/award channel. Purchases of less than $2,500 are exempt from the contracting registration requirements discussed above, and federal agencies may make them directly by using a government purchase card (GPC). Clients' best way to attract such small purchases is through normal business channels such as Yellow Pages advertisements and direct-marketing efforts.

> Meeting regularly with local contracting officers—who buy a wide range of goods and services but have a hard time keeping track of all the local vendors—can pay large dividends.

» Practical Tips

- Make sure clients obtain a data universal number (DUNS).
- Impress upon your clients how important it is to study a solicitation and identify its criteria.
- Determine the client's industrial classification code under the North American Industry Classification System (NAICS).
- Find and talk to the designated full-time small business specialist whose job it is to fulfill purchase "targets" for specific federal agencies.
- Meet regularly with local contracting officers to learn about past and future acquisitions; bring clients with you.
- Clients can register multiple business lines, some of which might meet the small business criteria, a category with special advantages.

Many prime contractors—those firms that are awarded very large projects or systems-development contracts—have targets as well as financial incentives they try to fulfill through subcontracting. These represent significant business opportunities. You can identify prime contractors working in your region through the Directorate for Information Operations and Reports (**http://siadapp.dior.whs.mil/**). Reports are available by region and identify all large-dollar contracts and contractors.

Another useful source is the military's long-range acquisition estimates, which forecast anticipated procurements for military installations for the current fiscal year and beyond (**www.selltoairforce.org/opportunities/lrae.asp**). These are helpful in identifying upcoming solicitations and making the necessary preparations to compete successfully.

An equally good strategy is to ask the contracting offices in your area what purchases they've made over the past year(s) to identify those products that have been most in demand. A CPA firm could collect and maintain a database of purchases in its region and provide analysis to help clients obtain contracts.

Despite the e-commerce focus of government contracting, adding a personal touch is a key strategy. Meeting regularly with local contracting officers can pay large dividends. Since they buy a wide range of goods and services, it is difficult for them to keep track of all the local vendors, especially the smaller ones. Regular meetings with them provide useful information about past and planned future acquisitions, preparing you to offer even better service to your clients.

Even though your clients may find it overwhelming to navigate through the procurement process to win federal government contracts, with your help and knowledge your clients can make the dream a reality. ❖

8(a)-Designated Small Businesses

Qualifying minority and/or economically disadvantaged businesses get a special break in the form of the Small Business Administration's 8(a) designation. The SBA confers 8(a) status after documenting and verifying a small business's need.

Some minority-owned businesses qualify automatically (for example, Alaskan- and American Indian-owned businesses). Other minorities must demonstrate both economic and political disadvantage. Qualification has significant economic benefits. These entities can request and receive noncompetitive awards of as much as $3 million from federal agencies. It is desirable but not required that 8(a) entities participate directly in providing the goods or services that are the subject of the contract; in fact, forming joint ventures is common with established businesses.

AICPA RESOURCES

Practice Aid

CPA Marketing Tool Kit offers tools to help members promote their practices and services, **www.aicpa.org/Professional+Resources/Public+Accounting+Firm+Resources/CPA+Marketing+Toolkit/**.

CPE

■ Successful Selling Strategies for CPA Firms (DVD/Manual (79-min. video), # 181190XUJA; Manual for DVD, # 351191XUJA).

Publication

■ *Management of an Accounting Practice Handbook* (loose-leaf version, # 090407JA); e-MAP (online version, # MAP-XXJA).

For more information or to make a purchase, go to **www.cpa2biz.com** or call the Institute at 888-777-7077.

Economics of Scale

Help clients step into the big leagues and your firm will benefit as well.

by Carl J. Lacher

When clients land a really big opportunity, it rarely is unalloyed good news. To fulfill a supersize order, companies often have to scramble to ramp up and their risks increase dramatically. In "extreme-growth" situations huge orders create problems—from financing to accounting, taxes and human resources—for modest operations. Here are pointers to help clients secure capital, resources and management skills to meet suddenly escalated demands, along with real-life details from our firm, Lacher MacDonald & Co., in Seminole, Fla.

Key Factors: Capital and Mind-set

Faced with a major deal, small companies may instantly need more equipment, space, inventory and people to do the job. Their working capital, adequate for existing operations, is insufficient for such growth; they need to obtain new capital quickly while simultaneously managing the physical aspects of the opportunity.

Psychology is a factor, too. Entrepreneurs are accustomed to pushing rather than managing to get things done—but even excellent financing can be lost through poor management. Good management and advice, however, can help clients successfully achieve goals that expand their capabilities. CPAs can assist with staffing, accounting and treasury functions and even become a liaison to a major supplier.

Housewares Department

Two years after we fired a client for nonpayment, its management came back to request our help with an opportunity beyond its "wildest dreams." The company had hung in and had at last won a bid to supply aprons and a few related dry-goods items to a big box store. Its revenues would increase tenfold in two years if it could deliver.

We agreed to help, but the company's payment history was a complicating factor. We set a limit on how much our firm would carry in accounts receivable; anything unpaid for more than one year would impair our independence. The big

box store's requirements were Draconian as well: It required delivery within 10 days of placing an order, including the initial one, and would penalize mistakes in shipping and/or documents by reducing the amount it paid.

WE WENT TO WORK

A plan always helps to banish uncertainty, so the order of business was to:

Help the owners focus. First we helped the owners sort out the priorities. We created flip charts of the company's immediate needs and worked out what had to be done in what order. Our firm remained in daily contact and averaged four face-to-face meetings with the owners per week as the engagement progressed.

Be flexible about solutions. The company had no up-front capital and also needed inventory, physical space and equipment. The first big fix came when the owners found a supplier who agreed to accept payment when the company was paid, with the important stipulation that payments be remitted to our firm; we would split the funds between the supplier and our client. An attorney helped us shape an agreement specifying that we bore no legal responsibility for the funds received.

We established a dedicated bank account that was the client's property into which we put all receipts and from which we made the split disbursements. We never mingled this project money with the firm's or with the client's general operating accounts, over which we had no control.

Communicate thoroughly and widely. More working capital surfaced when a local group of retired businesspeople became aware of the project and offered the company a loan. This provided desperately needed funding for equipment and was the catalyst that launched the project. The group's primary condition for participation was a quarterly report from the client, including a narrative description of business progress, which we helped the owners write.

Help the client negotiate. We learned early in the project that helping to communicate the financial details between our client and third parties would be our greatest contribution to a successful outcome. The client was too busy with operations while we had the advantage of being impartial outsiders who were able to speak the lingo.

One of the client's problems, for example, was that its existing facility was woefully inadequate. In fact, delivery of initial shipments was possible only because a severe drought let the company stack boxes on its front sidewalk for the freight service pickup. We helped the client negotiate a lease for a warehouse/office facility. It wasn't perfect, but it was a major improvement over the sidewalk.

Point the client in the right direction. The big box store ordered, canceled and had problems with the items; it returned one apron model and took one case as a credit. We convinced the client that hiring a very strong accounts-receivable person could stop the confusion and suggested it run an ad in the free neighborhood paper to attract capable local people. (In our experience, such papers make a good resource for filling nontechnical positions). The client took our advice, found someone—and its collection experience with the big box store improved dramatically.

Calm fears. The supplier frequently was fearful about its accounts receivable and inventory, so the client asked us to visit its supplier's big-city office several times to allay any concerns. On behalf of the client, we told the supplier, "If these millions of sales dollars are not worth the risk, then kill the deal—but you are being treated honestly." Our presence reassured

We learned early in the project that helping to communicate the financial details between our client and third parties would be our greatest contribution to a successful outcome.

EXECUTIVE SUMMARY

- **Faced with a major piece of new business,** many clients find they instantly need more equipment, space, inventory, people and working capital. They must obtain capital quickly while simultaneously managing the other, physical aspects of the total opportunity.
- **Many entrepreneurs are accustomed to pushing rather than managing** to get things done, but even excellent financing can be lost through poor management. Good management can help clients successfully achieve goals that expand their capabilities.
- **In extreme-growth situations,** CPAs have to help clients focus on the business priorities. Start by listing the company's immediate needs and working out what has to be done in what order.
- **Flexible solutions can be a great help**—for example, the CPA firm can take charge of receivables and disbursements to ease supplier concerns.
- **Investors are reassured** when the business communicates its progress frequently and thoroughly; that's a task CPAs can ably perform for clients.
- **CPAs can help get the right people.** A strong accounts-receivable person can ease confusion. Timely and accurate financial reporting is vital since everyone has to know as soon as possible how well or poorly the business is doing.
- **CPAs who consult on extreme-growth projects** must adhere to ethical standards, know business planning in its classic forms, understand compliance regulations and have the ability to be assertive with and for the client.

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the supplier, who needed to put risk vs. return into perspective.

Our client did every inventory count, which matched an almost full sample done by the supplier. It was an added challenge to work with people who were very suspicious—and prove their concerns groundless.

Get the right help. Timely and accurate financial reporting was vital since we all had to know as soon as possible how business was going. We helped the client recruit its controller by looking in our "resumes for clients" file. We told her it would be the experience of a career and, to this day, we all agree. She had financial statements to us the first working day of the month nearly without fail—historical financial information was *not* ancient history.

Happy Ending

The client found the financing, the space and the supplier. We provided the management consulting, business planning and help with communications to make the paperwork side of the equation work. We shared in the delays, victories, shipments, hirings and firings. Ultimately, the supplier bought the client. We were paid in full for our work, and the project was one of the most interesting of all our careers.

Our firm's takeaways from this project included these lessons:

- Informed but dispassionate communication with company outsiders such as investors and suppliers is a vital service CPA firms can offer.
- Strong control and reporting are best achieved by helping the client hire the right people for the jobs.
- A CPA firm can serve as the central point for collections and disbursements to satisfy all parties.

Media Umpire

Along these same lines, our firm had another major opportunity—management consulting for a start-up television station. Our services included providing a forecast and attending almost all of the client's board of directors meetings for 12 years. Frequently, we injected independent thinking that brought about changes in direction or cooled emotions before they could escalate into problems.

Starting out, we recognized the client needed:

Planning. The group of founders had the advantage of possessing significant radio broadcasting and business management experience. But the issues that arose early on were daunting: Could they obtain the licenses, a combination of locations for remote transmission with urban administration and attract the right programming and advertisers? This was a major task for the group but also a giant opportunity.

The CEO focused on the dual nature of the opportunity: first, to achieve maximum operating success with limited resources and, second, to position the station for the best deal when a buyout opportunity appeared.

Documentation. The client had funding for the initial work, but needed to raise capital to go on the air. We helped build the spreadsheets for the station's potential revenues and expenses, which ultimately became the forecast. We projected how much it would cost to start the operation—a figure necessary to enlist investors. We also looked into securities issues by bringing in an attorney who provided an excellent set of guidelines. We held many meetings with the CEO and top executives on the many changes.

Communications liaison. Our firm's work to improve company communication was as important as our accounting input. As outsiders, we could see the operating team lacked the time to address the information needs of the investor group; the managers—although highly experienced in broadcasting—were so busy that investor communications could easily have slipped. We witnessed several shareholder meetings that started acrimoniously and ended harmoniously.

The CEO was a receptive person, and we told him when we saw the need for improved communication. We had attended so many business meetings and teleconferences that we could cite for him specific examples where he had shown great skill at communicating to investors and others.

Adaptability. The station's credit policy raised a unique issue. Revenue was vital; super-strict credit policies could kill the business and, hence, were not an option. The station took on some poorer advertising accounts to initiate a revenue stream, but as its position strengthened it was able to attract more reliable customers. This constant blending toward the middle to minimize bad debts was a key component of the company's success.

Firm financial management. When a board member found a qualified controller and the station asked for our opinion, we voted emphatically "yes." He improved controls, reporting and timely flow of information to management and was a valuable addition to the team.

Complex debt settlement. Ultimately, the station was sold. Tax planning was only part of the project. The corporate

AICPA RESOURCES

The Institute offers a range of teaching and practice development resources for niche consulting. Go to **www.aicpa.org** and **www.cpa2biz.com**, and type in *consulting* and the specialty you're interested in.

Conference
Practitioners Symposium
June 4–6, 2007
Sheraton Wild Horse Pass Resort and Spa
Chandler (Phoenix), Ariz.

Publications

- *e-MAP: Management of an Accounting Practice Handbook* (#MAP-XXJA).
- *Management of an Accounting Practice Handbook*, vols. 1, 2 and 3 (#090407JA).
- *Marketing a Consulting Niche*, edited by Allan Koltin (#056508JA).

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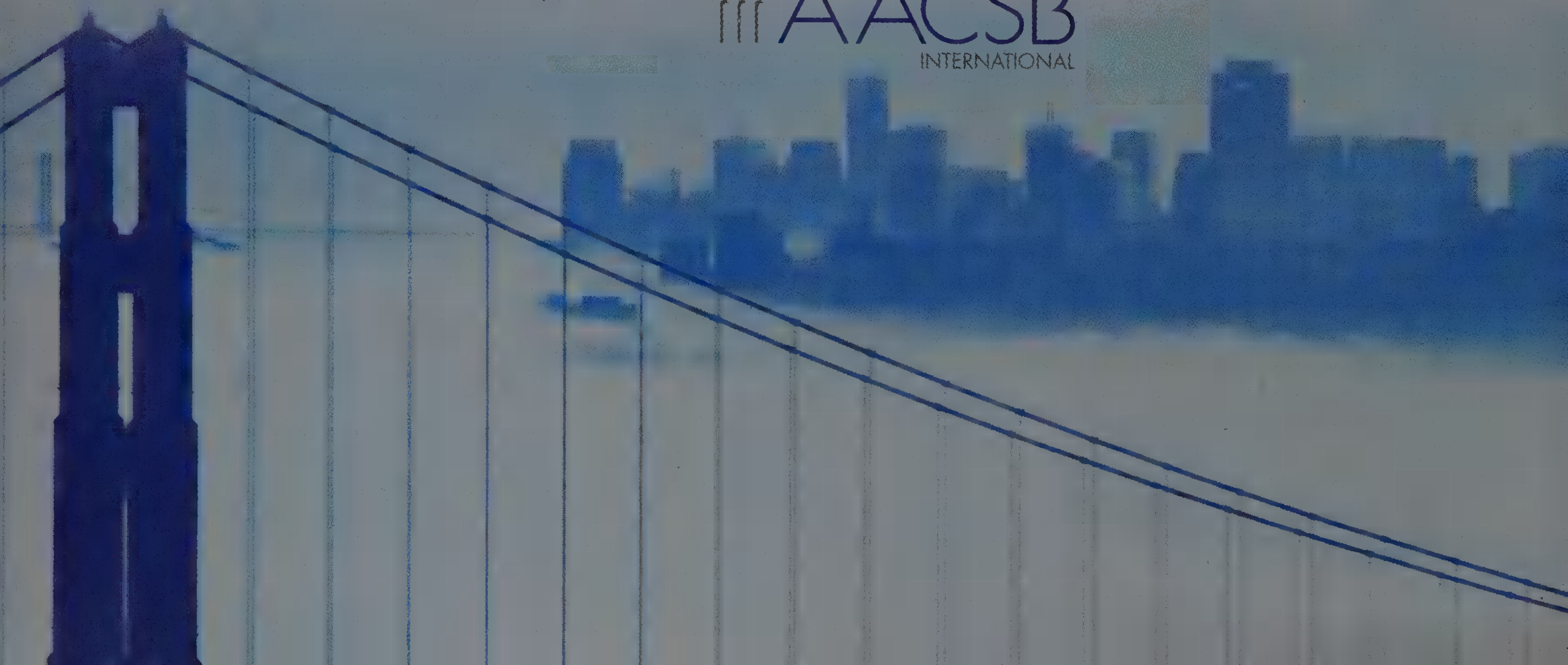
Web sites

- CPA Marketing Tool Kit, **www.aicpa.org/cpamarketing**.
- PCPS Firm Practice Center, **http://pcps.aicpa.org**.



involvement included vendor and customer claims that could not be handed over to a buyer. The client formed a trust to handle these claims after the sale.

It was interesting to watch as the owners collected on claims and as claims against them were settled in their favor. The tenacious CEO had fostered a transparent climate and then assertively stood his ground where necessary. Good information paid off. We worked with management to distribute the funds and close down the trust, a process that took more than two years.

Along the way, we were offered an equity position but refused it to maintain our independence. Later several owners told us how much they respected us for our position. It was one of our best decisions.

We shared the experience of this company's coming to life and struggling through the first years. It was truly a career-building and exciting experience for everyone involved. Our firm's takeaways from this project included the following:

■ Informed, dispassionate communication with people outside the management team, again, was a vital service.

■ Working with knowledgeable managers from a variety of backgrounds (many of whom we would not otherwise have met) was an experience to value forever.

■ Good documentation empowered the client to hold its positions and satisfactorily settle any claims outstanding at the date of sale.

Practice Opportunities

When a local client has the chance of a lifetime, CPAs can be its best advisers. Like our firm, you can be a sounding board for clients who need guidance and help to nurture their success. Major projects require thinking outside the compliance-only box and an understanding of business management based on wide-ranging experience. Such projects are more than just debits, credits and taxes—they offer the excitement of challenge. Our clients' technical capabilities have landed the deals; we've helped them make it work—and everyone has won. ❖

» Practical Tips

- ▶ Be a go-between: Communicate clearly to company outsiders as well as owners.
- ▶ Help the client hire the best people for financial control and reporting.
- ▶ Suggest the client put an ad in a free neighborhood paper to attract highly capable local people for nontechnical positions.
- ▶ Recommend a trust for a complex post-sale debt-settlement process.
- ▶ Make sure clients maintain good documentation.

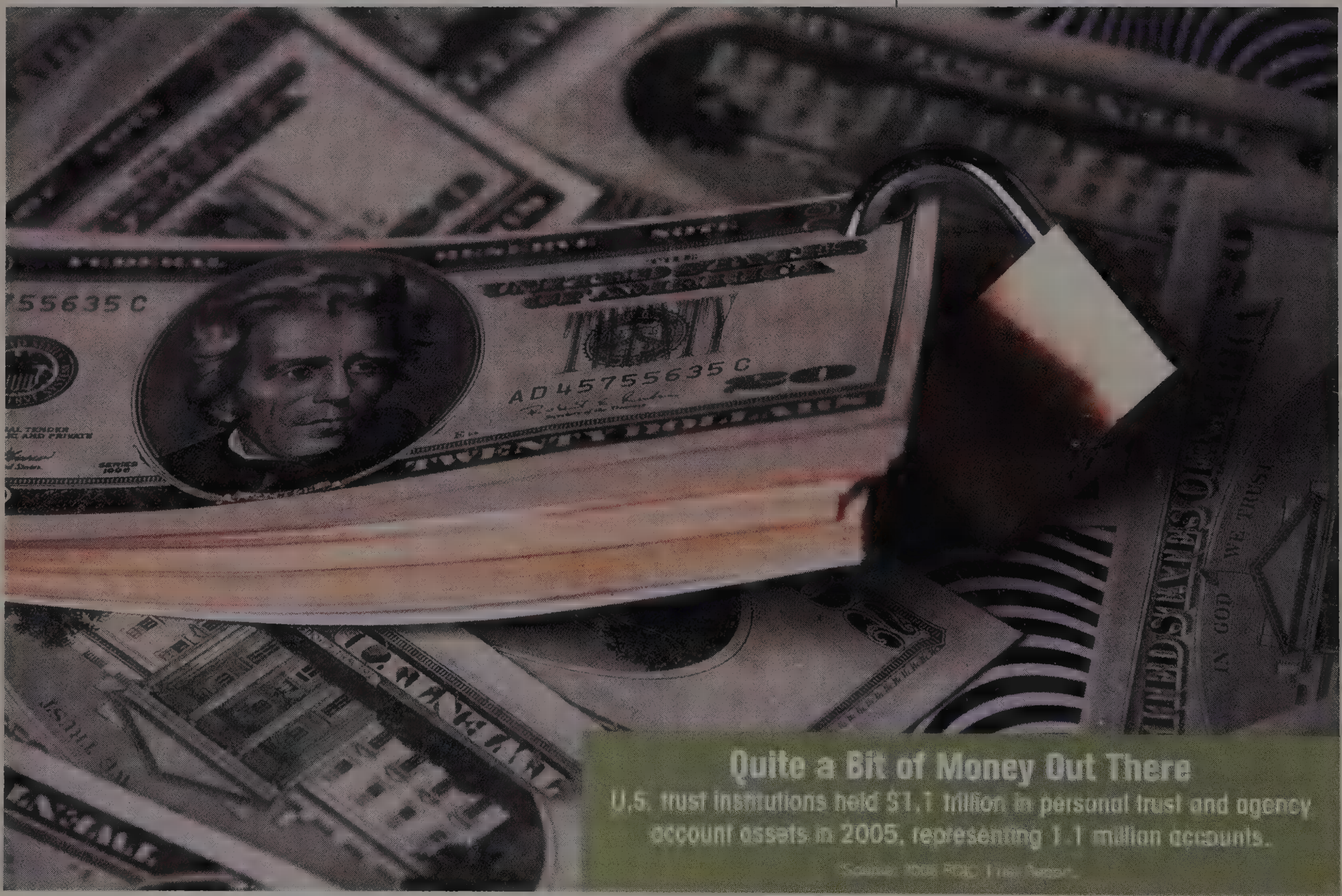
CPAs as Trust Protectors

Helping clients build flexibility and additional oversight into their trusts is a manageable, meaningful new niche.

by Michael B. Allmon

Clients who want their beneficiaries to avoid the stress, expense and delay of probate often place assets in trust. Increasingly they are asking their CPAs in both public practice and industry to act as trustees. However, many CPAs are reluctant to take on the fiduciary responsibility of being a trustee for several reasons: They lack adequate infrastructure and staff for trust administration; they are inexperienced in trustee work, especially for real estate and other nonliquid assets; and they are uncertain about how to bill appropriately.

An alternative to acting as trustee is to be a "trust protector" alongside a professional trustee. This article will



Quite a Bit of Money Out There

U.S. trust institutions held $1.1 trillion in personal trust and agency account assets in 2005, representing 1.1 million accounts.

examine the basic definition and duties of a trust protector, offer reasons CPAs are an excellent fit for the trust protector role, describe potential pitfalls of the arrangement and their solutions, and suggest why CPAs should want to act in this capacity.

The idea of employing a trust protector has grown in popularity in reaction to the increasingly unpredictable nature of changing law and tax policy.

FROM PLANNING TO PROTECTION

A trust protector is a third party (neither trustor nor trustee) who has been granted contractual powers to protect the terms of a trust. The concept—relatively new for onshore trusts—is common in offshore asset protection planning. A trust protector can assist in guiding both corporate trustees and trust beneficiaries through legal and tax complexities to carry out the client's original intent. The idea has grown in popularity in reaction to the increasingly unpredictable nature of changing law and tax policy.

A trust protector's authority lies in the powers and duties spelled out in the trust document (the contract). When the client uses a trust protector, the main trustee becomes an excluded fiduciary in those areas in which the trust protector is empowered. Generally, trust protector powers include some or all of the following:

■ ***The ability to remove and replace a trustee.*** The most common—often the only—power of trust protectors is the ability to replace a trustee who is unresponsive to the needs of the beneficiaries or who is not performing to the standard required by the trust's investment policy statement (IPS). The IPS outlines how the trustee is to manage the trust's investment portfolio and addresses risk tolerance, goals and asset allocations. It should be reviewed periodically.

■ ***The power to change*** situs ***of administration.*** The *situs*—the trust's legal "home," which determines which state's laws will apply—is an important factor in its administration. Sometimes estate planning attorneys will recommend that a trust have a situs in a state other than the one in which the trustor lives. For instance, trusts sited in California having non-California beneficiaries are subject to a complex tax formula; using another state for the situs could reduce the trust's state income taxes. Consult the trust's attorney when a trust situs differs from the trustor's home state. Changes in law occurring after the trust document has been prepared also can make it advisable to move the trust situs.

■ ***The power to resolve deadlocks between co-trustees.*** This is sometimes referred to as "tie-break" power.

■ ***Discretion to veto investment decisions, redirect trust distributions or***

» Practical Tips

To limit potential liability:

▶ Research how your state views trust protectors, and make sure you fully understand the applicable laws in your jurisdiction.

▶ Consult an estate planning attorney with knowledge of your present and potential area of practice.

▶ Find out whether your malpractice carrier will cover you for trust protector services.

EXECUTIVE SUMMARY

■ **Clients who want their** beneficiaries to avoid probate often place assets in trust. Many CPAs are reluctant to take on being a trustee, which is a time-consuming responsibility. An alternative is to be a third-party "trust protector" alongside a professional trustee. CPAs are highly qualified for the trust protector role because they have the client's confidence, the right skill sets, a tax background and an understanding of the client's family dynamics.

■ **A trust protector has** contractual powers (described in the trust document) to assist in guiding both corporate trustees and trust beneficiaries through legal and tax complexities to realize the trustor's original intent. Using a trust protector provides an added safeguard over the actions of an appointed corporate trustee. The concept is common in offshore asset protection planning.

■ **A trust protector can** generally remove and replace a trustee; terminate the trust; change the situs of administration; resolve co-trustee deadlocks or beneficiary-trustee disputes; veto investment decisions; and redirect trust distributions or amend administrative provisions and trust terms based on unforeseen circumstances in the beneficiaries' lives or changes in law.

■ **Few statutes define** and regulate the role of trust protector, and only a few domestic jurisdictions recognize it (Alaska, Delaware, Idaho, South Dakota and Wyoming). There is little domestic case law to address issues such as who is checking the trust protector's powers, the trustee's role if those powers are broad, or terms of succession for the role.

■ **Because the role is not defined** in most states, there is potential legal liability. Contentious beneficiaries could argue that a protector acted imprudently or improperly. Other drawbacks to be managed include an uncertain fee structure and the always-present issue of uncertain timing.

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amend administrative provisions and trust terms based on unforeseen circumstances such as divorce, irresponsibility or changes in law. For instance, a trust protector might decide that distributions to a beneficiary who is in a temporary situation such as a divorce or credit action, or who has become drug addicted, should be modified. Changes in estate tax laws also might provide reasonable grounds for the protector to act to amend the trust document.

■ ***Ability to terminate the trust.*** This might apply when the trust is no longer large enough to warrant ongoing administrative costs and continuing it is not in the beneficiaries' best interests. For example, I am trustee of a trust (formerly a protector of this trust) that had six beneficiaries. As each beneficiary turned 21, his or her portion of the trust was distributed. The last beneficiary is much younger than the others, so the trust might not have enough assets to cover its management costs until that beneficiary turns 21. Based on cost considerations, it would make sense to distribute the remaining funds early.

■ ***Dispute resolution between beneficiaries and the trustee.*** A trust protector who arbitrates disputes can reduce the trust's litigation costs.

As this list shows, using a trust protector lets a trustor extend control and build flexibility into an otherwise rigid document long past the time when he or she is deceased. Such capacity makes it more likely that the spirit of the trust ultimately will be carried out, even in a changing legal, tax and economic environment.

Another benefit for the trustor is the trust's ability to adapt terms to the changing circumstances of beneficiaries. Finally, a trust protector provides an added safeguard over the actions of an appointed corporate trustee, who may not know or understand the client's family dynamics.

Case Study
It Works Well for Me

Clients sometimes ask me to act as trustee of their estates, but based on my executor and trustee experiences, I think CPAs can best serve clients by monitoring the actions of the primary fiduciary rather than being the primary fiduciary.

In 1995, I became an acting co-trustee and executor for a client who died and left a large and complex estate, primarily in trust. My duties included everything from ensuring two steel companies were managed efficiently (they were responsible for the section 6166 estate tax payment plan that I negotiated with the IRS), handling potential toxic contamination claims, settling document disputes, dealing with numerous tax matters (income, estate and excise taxes) and beneficiary issues (such as a claim not authorized in the documents) to the more usual activities of a fiduciary—investing and communicating to all beneficiaries.

Once the complex issues were settled, my co-trustees resigned. I remained as sole trustee. I then found a national trust company to accept all liability for any actions, to handle all matters in a trustee role, and to share the trustee's compensation with me. By our agreement I voluntarily created a trust protector role for myself and gave up all authority to act—except for the power to replace that trustee with anyone I chose, including myself. My CPA firm continued to provide tax services to the trust.

So far, I have had to replace the acting trustee twice. The first time I changed trustees because of a change due to a merger of the trust company. The second time was due to an unresponsive and difficult trustee (they were not providing timely accounting information that we needed to prepare income tax returns, nor were they meeting our investment objectives, as spelled out in the trust's investment policy statement).

I now ask my clients to have their trust documents name me as either trustee or protector. When I am named as trustee, I usually have the ability to replace myself and limit my responsibilities to the role of a trust protector.

NOT A CURE-ALL

Many issues that arise with the choice of a trustee also are present in choosing a trust protector. For instance, the inherent conflict of interest between current beneficiaries and remaindermen (inheritors whose estate vests after a prior estate terminates) is not eliminated by the addition of a trust protector, no matter how sagacious the chosen party. (This is particularly true if the trust protector is also a beneficiary of the trust.) Nor is there much domestic case law to address other unresolved issues such as:

■ Who is checking the powers wielded by the trust protector?

■ What is the trustee's ultimate role if the trust protector's powers are broad?

■ What are the terms of succession for the role?

Few statutes define and regulate the role of trust protector, and only a few domestic jurisdictions recognize the concept (including Alaska, Delaware, Idaho, South Dakota and Wyoming). To

limit potential liability, research the laws of your state to ensure you fully understand the applicable laws.

WHY CPAs ARE A GOOD FIT

CPAs are highly qualified for the trust protector role because they:

■ ***Have the client's confidence.*** A trust protector should be unassailably objective, especially given unresolved issues in the law and the inherent conflict of interest between beneficiary and remaindermen and between beneficiary and trustee. Clients see their CPA as a reliable, trusted adviser.

■ ***Have the knowledge.*** CPAs have the education, training and experience to handle the role. Their working knowledge of a range of financial instruments can help them judge how well the trust's investment policy is being executed.

■ ***Understand the clients.*** Clients want someone who is intimately familiar with the family's financial situation and long-term goals for passing wealth to the next generation. For many families that person is their accountant. Sometimes a family's CPA knows their financial situation as well or better than they do.

■ ***Have a tax background.*** CPAs' knowledge of tax law puts them in a good position to determine whether changes in the law will necessitate changes to a client's trust.

> Limited only by state law, the role of trust protector can take on almost any characteristic clients and their estate planning advisers can imagine.

PROTECTORS' RISKS

A trust is a contract that offers tremendous potential flexibility. Limited only by state law, the role of trust protector can take on almost any characteristic clients and their estate planning advisers can imagine. But as with nearly all new areas of practice, there are some risks for pioneers. A CPA who chooses to act as a trust protector will have to manage:

■ ***Potential legal liability.*** Because the functions of a protector are not defined in most states, contentious beneficiaries could argue that a protector acted imprudently or improperly. Before agreeing to act as your client's trust protector, consult an estate planning attorney, research how your state views trust protectors, and find out whether your malpractice carrier will cover you in that capacity.

■ ***Uncertain fee structure.*** Still-developing laws in your state may not address the issue of fees for trust protectors. A protector's fees might possibly be covered by total trustee fees where such fees are defined as "fair and reasonable." To be safe, obtain your client's agreement to add language to the trust document to ensure payment of your fees for both fiduciary and accounting services for the estate. Clients who ask you to serve will want you to be motivated to act on their behalf and to be properly paid for doing so. Weigh the potential for earnings against potential liabilities in accepting the trust protector role.

■ ***Uncertain timing.*** Neither trustee nor trust protector can know when his or her service to the client will begin. During busy season a CPA would find it almost impossible to do the job of trustee; because being a trust protector is the less time-consuming role, the CPA can still satisfy the client's wish to obtain his or her continued judgment in the disposition of the estate even in the face of uncertain timing.

MANAGEABLE AND MEANINGFUL

CPAs are uniquely qualified to serve as trust protectors, an engagement that offers an attractive alternative to the nearly full-time job of trustee. Performing the service in conjunction with a corporate trustee will let you serve your client's best interests and solidify the relationship. It shifts responsibility for day-to-day trust administration to another entity, yet gives you a degree of oversight.

When properly drafted within the trust document, the balance of power between the two roles can serve to best reflect the trustor's original intent well beyond his or her lifetime. The oversight of a trust protector in domestic trusts is likely to become a more common feature in years to come. CPAs are well positioned to take on the role. ❖

AICPA RESOURCES

Code

■ AICPA Professional Standards, Code of Professional Conduct, **www.aicpa.org/about/code/index.html/**.

Conferences

■ AICPA Conference on Tax Strategies for the High Income Individual
April 30–May 1
Bellagio, Las Vegas

■ Practitioners Symposium
June 4–6
Sheraton Wild Horse Pass Resort and Spa
Chandler (Phoenix), Ariz.

CPE

■ CPExpress: Estates & Taxes: Income Tax Fundamentals; Grantor Trusts (# HAP).

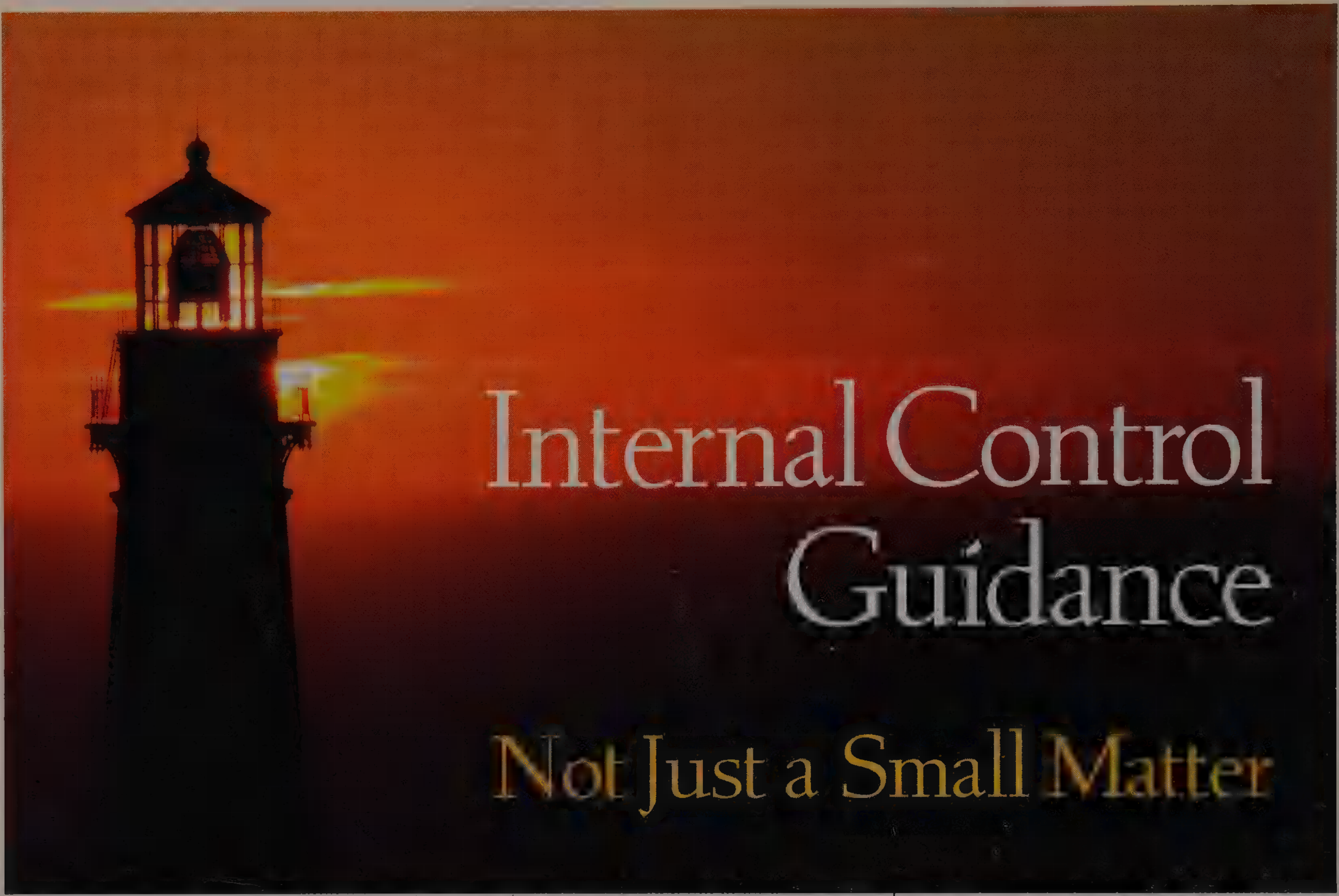
■ Income Taxation of Estates and Trusts (# 736943JA).

Web sites

■ AICPA Personal Financial Planning Center, **http://pfp.aicpa.org**.

■ AICPA Professional Ethics Division, **www.aicpa.org/members/div/ethics/index.htm**.

For more information or to make a purchase, go to **www.cpa2biz.com** or call the Institute at 888-777-7077.



Internal Control Guidance

Not Just a Small Matter

COSO's latest guidance on controls for smaller businesses fits all organizations.

by Larry E. Rittenberg, Frank Martens and Charles E. Landes

Managers of smaller businesses need to design and implement an effective system of internal control over financial reporting in a cost-beneficial way. To help achieve this, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) has provided guidance to smaller businesses in its publication *Internal Control Over Financial Reporting—Guidance for Smaller Public Companies* (**www.coso.org**). The guidance encourages CPAs to work with organizations to implement controls that are fundamental building blocks to success. Effective internal control over financial reporting, including management's understanding, design, implementation and monitoring, should be viewed as an important business function.

Often lost in the debate over the costs associated with Sarbanes-Oxley section 404 is the significant number of smaller businesses that fail, often because they do not have good business plans or do not identify and control risks. Research shows that a strong commitment to internal control is a matter of company priority, not a matter of resources. This guidance will help CPAs in industry and in public practice. CPAs in management will find it useful in implementing and evaluating internal control. CPAs in public practice will find it useful in assessing internal control over financial reporting

Reported internal control deficiencies went down in the second year of compliance with Sarbanes-Oxley section 404 by accelerated filers. In 2005, 15.4% of reporting companies had material weaknesses of internal control. In the first quarter of 2006, that dropped to 5.6%.

Source: Audit Analytics

and identifying the types of controls typically found in smaller businesses.

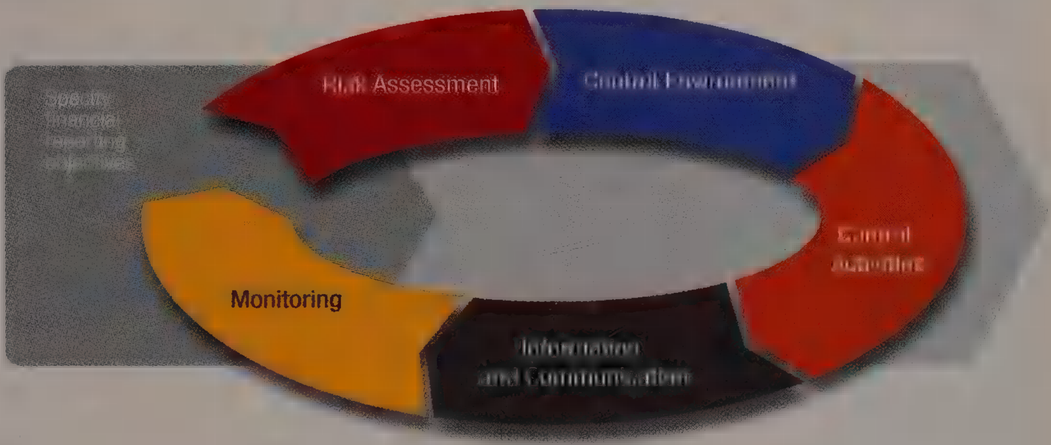
The guidance is drawn from the 1992 COSO *Internal Control—Integrated Framework* (IC Framework), which it clarifies but does not extend or replace. Focusing on the challenges faced by smaller businesses, the guidance explicitly addresses issues related to:

- Segregating accounting duties.
- Developing effective boards and audit committees.
- Managing with wider spans of control.
- Implementing sound information technology controls.
- Documenting the design and operation of controls.

The guidance comprises three volumes, each with a distinct purpose. Volume 1 features a high-level executive summary intended for top management and boards. Volume 2 presents practical guidance with real-life examples drawn from smaller businesses. Volume 3 provides evaluation tools to help management implement and evaluate internal control over financial reporting.

A Continuous, Integrated Process

Maintaining effective internal control is not static. Organizations have to expect that controls will change over time as risks and processes change. The guidance recognizes that an organization should have processes to update its identification and assessment of risks as well as to monitor the continuing effectiveness of its internal control system (see "Section 404 for Small Caps," *JofA*, Mar.06, page 67). The guidance is oriented toward objectives and principles. The fundamental principles are derived from the five COSO components—risk assessment, control environment, control activities, information and communication, and monitoring. Each of the principles is further described with key attributes that guide organizations in selecting the optimal control approach.



In this guidance, the traditional depiction of the internal control framework, usually shown and referred to as the "COSO Cube," is supplemented with a diagram that illustrates the logical relationship of the control framework, starting with management's objectives.

The logical interrelationship of the COSO components should help all companies plan their approaches to evaluating and updating controls. In understanding this relationship of controls and internal control components, COSO recognizes a systematic process whereby an organization:

- Specifies its financial reporting objectives (possibly influenced by regulatory requirements).
- Identifies and assesses the risks that may prevent it from achieving the desired objectives. Examples of the risks include management override, inadequate transaction processing and inappropriate accruals.
- Designs and implements a control environment that sets the tone for the organization and its commitment to financial competencies to mitigate risk.
- Designs and implements control activities—including authorizations, completeness tests and reconciliations—to further mitigate risks.

EXECUTIVE SUMMARY

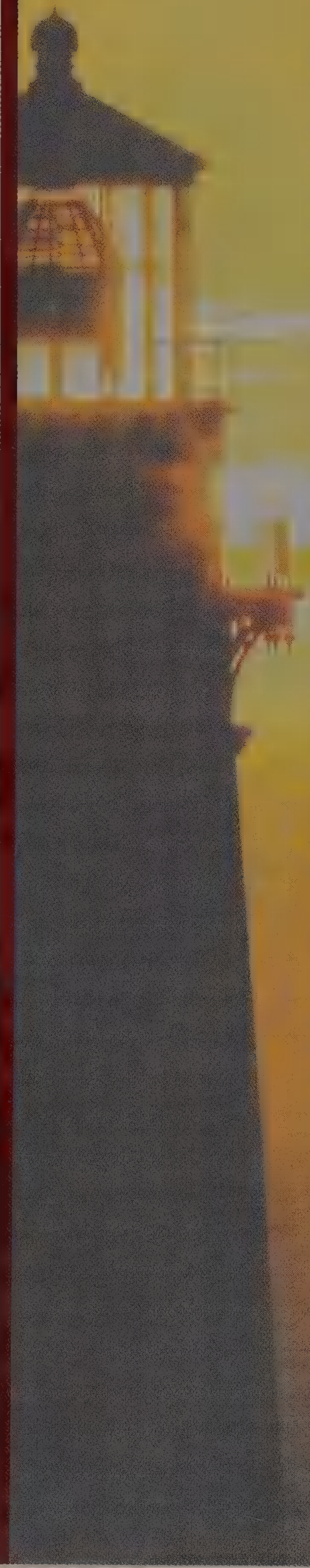
■ **In its most recent guidance** for compliance with Sarbanes-Oxley section 404 requirements for smaller entities, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) has provided principles and examples of effective internal control. Titled *Internal Control Over Financial Reporting–Guidance for Smaller Public Companies*, the guidance emphasizes the business function and cost-effectiveness of internal control. Although the guidance is specifically tailored to smaller public companies, it can be applied to all organizations.

■ **Five components of COSO's control framework** may be viewed as both fundamental principles and an aid to planning, evaluating and updating controls. They are risk assessment, control environment, control activities, information and communication, and monitoring.

■ **Management can monitor controls most efficiently** by integrating monitoring activity into financial reporting processes. Principles of effective internal control should not be considered a checklist but should be implemented in accordance with managers' judgment, with a formality of structure appropriate to the size of the organization.

Larry E. Rittenberg*, CPA, Ph.D., CIA, is chairman of COSO and Ernst & Young professor of accounting at the University of Wisconsin at Madison.* ***Frank Martens****, CA, is director of advisory services at PricewaterhouseCoopers LLP in Vancouver, British Columbia, and project team manager for* Internal Control Over Financial Reporting–Guidance for Smaller Public Companies. ***Charles E. Landes****, CPA, is vice president, AICPA professional standards and services, and represents the AICPA on COSO's board. Their e-mail addresses, respectively, are lrittenberg@bus.wisc.edu, frank.j.martens@ca.pwc.com and clandes@aicpa.org.*

Principles of Effective Control Over Financial Reporting



Control Environment

1. Integrity and ethical values. Sound integrity and ethical values, particularly of top management, are developed and understood and set the standard of conduct for financial reporting.

2. Board of directors. The board of directors understands and exercises oversight responsibility for financial reporting and related internal control.

3. Management's philosophy and operating style. Management's philosophy and operating style support achieving effective internal control over financial reporting.

4. Organizational structure. The company's organizational structure supports effective internal control over financial reporting.

5. Financial reporting competencies. The company retains individuals competent in financial reporting and related oversight roles.

6. Authority and responsibility. Management and employees are assigned appropriate levels of authority and responsibility to facilitate effective internal control over financial reporting.

7. Human resources. Human resource policies and practices are designed and implemented to facilitate effective internal control over financial reporting.

Risk Assessment

8. Financial reporting objectives. Management specifies financial reporting objectives with sufficient clarity and criteria to enable the identification of risks to reliable financial reporting.

9. Financial reporting risks. The company identifies and analyzes risks to the achievement of financial reporting objectives as a basis for determining how the risks should be managed.

10. Fraud risk. The potential for material misstatement due to fraud is explicitly considered in assessing risks to the achievement of financial reporting objectives.

Control Activities

11. Integration with risk assessment. Actions are taken to address risks to the achievement of financial reporting objectives.

12. Selection and development of control activities. Control activities are selected and developed considering their cost and potential effectiveness in mitigating risks to the achievement of financial reporting objectives.

13. Policies and procedures. Policies related to reliable financial reporting are established and communicated throughout the company, with corresponding procedures resulting in the implementation of management directives.

14. Information technology. Information technology controls, where applicable, are designed and implemented to support the achievement of financial reporting objectives.

Information and Communication

15. Financial reporting information. Pertinent information is identified, captured and used at all levels of the company and distributed in a form and time frame that supports the achievement of financial reporting objectives.

16. Internal control information. Information used to execute other control components is identified, captured and distributed in a form and time frame that enables personnel to carry out internal control responsibilities.

17. Internal communication. Communications enable and support understanding and execution of internal control objectives, processes and individual responsibilities at all levels of the organization.

18. External communication. Matters affecting the achievement of financial reporting objectives are communicated with outside parties.

Monitoring

19. Ongoing and separate evaluations. Ongoing or separate evaluations enable management to determine whether internal control over financial reporting is functioning.

20. Reporting deficiencies. Internal control deficiencies are identified and communicated in a timely manner to parties responsible for taking corrective action, and to management and the board as appropriate.

■ Develops an effective information and communication process that enables relevant parties to understand their control responsibilities and ensures management receives timely and relevant reports that facilitate effective investigation and decision making.

■ Monitors the effectiveness of its internal control system.

The objective of internal control over financial reporting is to achieve reliable financial reporting. Management's annual assessment of internal control effectiveness should be based in large part on the monitoring of control effectiveness. That monitoring should also incorporate a systematic process to identify emerging risks of misstatement, so that the design of the internal control system is continuously improved to mitigate new risks.

Management Assessment of Internal Control

Many businesses have viewed the assessment of internal control over financial reporting as a separate task from managing their day-to-day activities. By allowing these two areas to converge, management will attain greater efficiencies. This may occur through greater reliance on monitoring activities within a company or through the re-engineering of current processes. Management can obtain significant efficiencies if it integrates monitoring activities across its financial reporting processes rather than thinking of its section 404 assessment as a separate process on top of the IC Framework. This may provide management with sufficient assessment evidence of whether its system of internal control is effective over time.

The COSO board and supporting task force reviewed numerous smaller companies, both public and nonpublic, for examples of good internal control. That review underscored a fundamental COSO viewpoint that management judgment is important. Management should be empowered to choose the best set of controls because it is in the best position to decide and because control needs will change over time. The guidance identifies three factors to consider when choosing a control. It should:

■ Reduce risk to an acceptable level.

■ Be cost-effective.

■ Contribute to the effectiveness of one or more of the five components of effective internal control in the COSO *Internal Control—Integrated Framework*.

Volume 3 of the guidance includes templates for approaching the control decision. Many are presented in a questionnaire form and are based on the fundamental principles of control discussed in Volume 2. The templates are available, with the purchase of the guidance, as a download in Microsoft Word, so they can be tailored to each organization.

> The guidance should assist both management and its auditors to move away from a "check-the-box" approach to one that focuses on accomplishing the organization's objectives.

Principles of Effective Control

The guidance includes 20 fundamental principles of internal control directly from the Framework and related to each of the five COSO internal control components (see accompanying list). The guidance includes attributes associated with each principle. Although it draws examples for smaller businesses, the principles apply to all organizations—large or small, public or not public, government and not-for-profit.

These 20 principles should not be viewed as a checklist for designing and achieving effective internal control. Effective internal control still depends on having the five internal control components in place and operating effectively, such that a company has reasonable—not absolute—assurance that it will prevent or detect material misstatements in a timely manner.

Rather, COSO views each principle as essential to effective implementation of the related internal control component. These attributes further guide control selection by making the expected characteristics of control more specific. For example, the guidance presents three attributes associated with the principle related to integrity and ethical values. To achieve a high level of ethical behavior, the organization should:

■ Articulate values in a clear statement of ethical values understood by personnel at all levels of the organization.

■ Monitor adherence to principles of sound integrity and ethical values.

■ Address deviation from sound inte-

COSO Project

COSO has undertaken a project to identify practical, cost-effective approaches organizations may use to monitor their controls. More detail can be obtained at **www.coso.org**. COSO expects to issue a white paper in early 2007 that better articulates the monitoring component of internal control over financial reporting.

The project will also identify best practices that companies are using or can use to develop better monitoring of their internal control effectiveness. In addition, the project will relate the monitoring component of the IC Framework to management's annual assessment and reports on internal control.

grity and ethical values promptly and appropriately.

These attributes, as well as all other principles and attributes included in the guidance, require judgments as to the most effective way to implement the controls. Thus, the control principles and attributes are designed to be scalable—less formal for smaller organizations and more formal for larger organizations, where communication is more indirect.

The Importance of Documentation

Many company officials would prefer to let controls operate without having to document them. Unfortunately, inadequate documentation is one reason many companies are surprised to find out their system of internal controls is not effectively designed or implemented.

Unfortunately, inadequate documentation is one reason many companies are surprised to find out their system of internal controls is not effectively designed or implemented.

Documentation provides guidance for implementing controls, can serve as a basis for training new personnel in implementing them and provides evidence they have operated effectively. All controls and their operation need some documentation. When management and auditors must attest to internal control effectiveness, documentation must be more formal. It is not possible simply to rely on a statement that management performed the control. When parties have to attest to the control, there must be some evidence it was working effectively.

Implications for CPAs as External Auditors

This guidance will be useful for external auditors in assessing the effectiveness of internal control over financial reporting. The guidance should assist both management and its auditors to move away from a "check-the-box" approach to one that focuses on accomplishing the organization's objectives through effectively addressing the 20 principles underlying the COSO IC Framework.

It also offers additional perspective on approaches suitable for public companies and should encourage a healthy dialogue between management and its auditors. The dialogue between management and its auditors will lead to more creative and effective implementation of internal control in many organizations. Similarly, the principles and attributes contained in the guidance provide leadership opportunities for CPAs in management positions to focus on internal control objectives, process reengineering and, most importantly, building effective monitoring into their control practices. As this article's title indicates, the fundamental principles of internal control are not just for small companies.

Achieving effective internal control over financial reporting is just one step to corporate success and longevity. Businesses should integrate internal control processes with a more comprehensive process of enterprise risk management to achieve broader strategic, operational, reporting and compliance objectives. Another COSO document, *Enterprise Risk Management: An Integrated Approach*, may also be of help. ❖

» Practical Tips

▶ Stress to your clients or management team the importance of having financially literate, independent directors. The audit committee should establish its agenda thoroughly and well in advance to help management plan for its expectations.

▶ Advise managers to address a range of preventive and detective controls across the organization, such as segregating cash payments and access to inventory, purchases and fixed assets.

▶ See Volume 2 of *Internal Control Over Financial Reporting—Guidance for Smaller Public Companies* for more illustrations of best practices for all 20 COSO principles.

▶ To obtain *Internal Control Over Financial Reporting—Guidance for Smaller Public Companies*, go to **www.coso.org/publications.htm** or **www.cpa2biz.com/stores/coso3**. The executive summary is available as a free download. All three volumes are available from **www.cpa2biz.com** as a PDF file download or paperback set.

AICPA RESOURCES

Publication

■ *Internal Control Over Financial Reporting—Guidance for Smaller Public Companies.* The guidance can be obtained at **www.cpa2biz.com**. (PDF file download, #990017PDF, members $50, nonmembers $75; paperback three-volume set, #990017, members $65, nonmembers $90; combined download and paperback, #990016HI, members $90, nonmembers, $125).

For more information or to order, go to **www.cpa2biz.com** or call 888-777-7077.

Web site

■ Smaller businesses are often challenged to find effective board members and audit committees with accounting and control expertise. The COSO guidance recognizes the important role nonpracticing CPAs can play in meeting those needs. The AICPA has developed its Audit Committee Matching System (**www.aicpa.org/info/committees/index.asp**) to help organizations find a source of independent talent. CPAs should market the database in their area.

***JofA* articles**

■ "Section 404 for Small Caps," Mar.2006, page 67.

■ "The Value Proposition," Sep.2005, page 77.

The Power of Arrays

The Excel tool that performs multiple functions in a single step.

by Paul Goldwater and Timothy Fogarty

One of the most powerful features of Excel is the array—a formula designed to act simultaneously on sets of two or more values in order to calculate other values. Yet, because arrays appear to be forbidding, few CPAs use them. This article is designed to dispel arrays' bad reputation and demonstrate how they can speed and simplify your work while making it less prone to errors. So get ready to overcome your bias against arrays.

We'll begin with the most basic array formula, and as we move—step by step—to more complicated ones, you'll see how powerful arrays can get. To make it easier for you to follow along, download an Excel file from **www.aicpa.org/download/pubs/jofa/mar2007/goldwater.xls**. The file contains two versions of each worksheet. One worksheet in each set has blank cells in which you can practice entering the arrays and other formulas mentioned in this article, while the other has all the cells already completed.

» Key to Instructions

To help readers follow the instructions in this article, we use two different typefaces: **Boldface** *type is used to identify the names of functions, menu items, agendas and URLs.* Sans serif *type shows the names of files and the names of commands and instructions that users should type into the computer.*

Average It

Accountants often need to tightly summarize data. Exhibit 1 uses a one-dimensional array formula on payroll information to calculate the average pay of each employee and the global average of all employees. (In your downloaded file, see the **Average It** worksheet).

Here's how we did it:

To calculate the average per employee, select the range G3:G7 and type this formula:

=(B3:B7+C3:C7+D3:D7+E3:E7+F3:F7)/5

Then press Ctrl+Shift+Enter, which does two things: It automatically places curly brackets—{ }—around the formula, labeling it an array formula, and simultaneously triggers the array calculation. The array formula now exists in G3 to G7 and cannot be changed except by rewriting the entire formula.

To calculate the average pay per month, select the range B8:G8 and type in this formula:

=(B3:G3+B4:G4+B5:G5+B6:G6+B7:G7)/5

Then press Ctrl+Shift+Enter. The global average for all employees is now in cell G8.

Rank It

Creating two-dimensional arrays is slightly more challenging. Consider again the payroll data of Exhibit 1. This time we want to rank the paychecks by size. To do that, copy the list of names (as shown in the lower half of Exhibit 2) and type this formula:

=RANK(B3:F7, B3:F7)

Press Ctrl+Shift+Enter, and presto, the data are ranked—a task that would be far more difficult without arrays.

Analyze It

Arrays also are useful when performing analyses that impose conditions upon mathematical operations. For example, say you have a spreadsheet loaded with sales data and you want to see various subsets of the data based on ranges of products' prices and quantity (see Exhibit 3). For this calculation we will use a single-cell array. (See the worksheet **Single Cell** in your downloaded file.)

If we want to know the sum of range B3:B7 by range C3:C7, typically we could create D3:D7 and place the sum in cell D8. However, an array formula in D9 would do the job in one pass:{=SUM(B3:B7*C3:C7)}

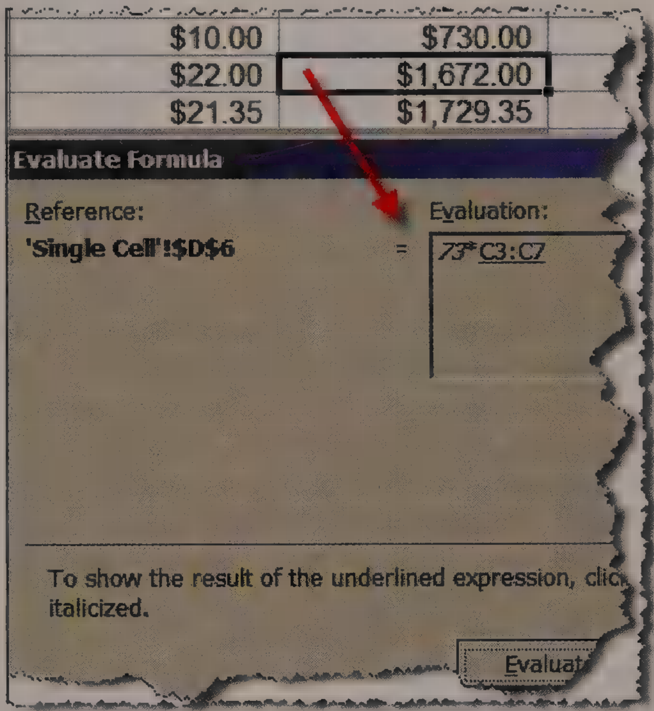
Exhibit 1

G3 | {=(B3:B7+C3:C7+D3:D7+E3:E7+F3:F7)/5}

	A	B	C	D	E	F	G
1	Employee Pay Checks						
2	Employee Name	Month 1	Month 2	Month 3	Month 4	Month 5	Average
3	Carothers, Andy	$555.19	$512.75	$530.60	$588.35	$516.46	$540.67
4	Groncki, Douglas	$547.09	$536.98	$556.81	$514.96	$549.71	$541.11
5	MacDonald, Scott	$540.85	$520.80	$530.73	$591.77	$559.99	$548.83
6	Nusbaum, Tawana	$554.00	$586.56	$571.79	$537.30	$520.96	$554.12
7	Rothenberg, Eric	$552.38	$557.03	$533.54	$534.62	$547.34	$544.98
8	Average	$549.90	$542.82	$544.69	$553.40	$538.89	$545.94

That simple formula extracts all the information from the underlying cells without the usual sum formulas in D3:D8. The grayed area at the bottom of Exhibit 3 (D9:D13) contains various array formulas to compute numerous values of interest to CPAs. Table 1 lists many of the typical ways CPAs are called upon to manipulate such data and the array formulas that perform each of those calculations.

Advisory: Often CPAs need to know, and perhaps to explain to clients or executives who are not handy in Excel, how certain spreadsheet numbers are derived (see screenshot at right). You can display this information easily by clicking on **Tools**, **Formula Auditing**, **Evaluate Formula**. This allows you to step through the calculations, first seeing cell references and then the numbers those references represent.



CALCULATE THE CONSTANTS

Arrays often need to import constants, including useful explanatory information such as dates, names and numbers. This comes up, for example, when you need to in-

Exhibit 2

B10 | {=RANK(B3:F7,B3:F7)}

	A	B	C	D	E	F	G
1	Employee Pay Checks						
2	Employee Name	Month 1	Month 2	Month 3	Month 4	Month 5	Average
3	Carothers, Andy	$555.19	$512.75	$530.60	$588.35	$516.46	$540.67
4	Groncki, Douglas	$547.09	$536.98	$556.81	$514.96	$549.71	$541.11
5	MacDonald, Scott	$540.85	$520.80	$530.73	$591.77	$559.99	$548.83
6	Nusbaum, Tawana	$554.00	$586.56	$571.79	$537.30	$520.96	$554.12
7	Rothenberg, Eric	$552.38	$557.03	$533.54	$534.62	$547.34	$544.98
8	Average	$549.90	$542.82	$544.69	$553.40	$538.89	$545.94
9							
10	Carothers, Andy	8	25	20	2	23	
11	Groncki, Douglas	13	16	7	24	11	
12	MacDonald, Scott	14	22	19	1	5	
13	Nusbaum, Tawana	9	3	4	15	21	
14	Rothenberg, Eric	10	6	18	17	12	

Table 1

Accounting question of interest	Cell	Formula
Sum (using arrays)	D9	{=SUM(B3:B7*C3:C7)}
Sum (if greater than the average price)	D10	{=SUM((C3:C7>AVERAGE(C3:C7))*B3:B7*C3:C7)}
Sum (if greater than the average quantity)	D11	{=SUM((B3:B7>AVERAGE(B3:B7))*B3:B7*C3:C7)}
Sum (if greater than the average price and greater than the average quantity)	D12	{=SUM((C3:C7>AVERAGE(C3:C7))*B3:B7*(B3:B7> AVERAGE(B3:B7))*C3:C7)}
Sum (if greater than the average price or greater than the average quantity)	D13	{=SUM(((C3:C7>AVERAGE(C3:C7))+(B3:B7> AVERAGE(B3:B7))>0)*B3:B7*C3:C7)}

clude transaction fees, such as sales taxes and shipping charges, in formulas. Exhibit 4 shows invoices both before the application of a 4% sales tax and a 1% shipping fee (column D) and after (column G). See the downloaded file's **Single Cell** worksheet.

This kind of array has to be created and then recalled by way of a drop-down menu, which is evoked by clicking on **Insert**, **Name**, **Define** (see Exhibit 5). Under **Names in workbook**, add the designation of a name such as StandardCharges, and in the **Refers to** field, add the specification of the percentage rates, such as = {0.04,0.01}. Both of these values could have been stored in separate cells on the spreadsheet. But often these values (constants) should be hidden or made inaccessible so the employees cannot easily change them.

Place the formula in the affected cells (in this case E3:E7 and F3:F7) that recall the percentage rates and apply them to the base amounts. For example, the sales taxes require this formula to be created as an array:

{=D3:D7*INDEX(StandardCharges,1)}

The shipping charge array requires selecting the second value from StandardCharges:

{=D3:D7*INDEX(StandardCharges,2)}

Let's look at three typical calculations CPAs face. For each, refer to Exhibit 6 and your downloaded worksheet **Calculate Constant**. Once again, use the **Evaluate Formula** tool to observe what Excel is doing for each of the following examples.

SUMMING BASED ON A CONDITION

When you need to sum values based on one or more conditions, the array formula (in D9) is:

=SUM(IF((D3:D7>=1000)*(D3:D7<1700),D3:D7))

This formula returns the sum of all cells in the range D3:D7 where the value is greater than or equal to 1,000 and less than 1,700. You can include more conditions in the array formula if necessary.

SUMMING THE *n* LARGEST VALUES IN A RANGE

Cell D10 contains this formula:

=SUM(LARGE(D3:D7,ROW(INDIRECT("1:2"))))

This formula returns the sum of the two largest values in the range D3:D7. **LARGE** is an Excel function that will be evaluated twice, each time with a different second argument (that is, 1, 2). Also, if you wish to sum the *n* smallest values in a range, use the Excel **SMALL** function instead of the **LARGE** function.

COMPUTING AN AVERAGE THAT EXCLUDES ZEROS

Often the use of averaging commands is distorted by the presence of zeros in the data. Zero may indicate that the transac-

Exhibit 3

D9 {=SUM(B3:B7*C3:C7)}

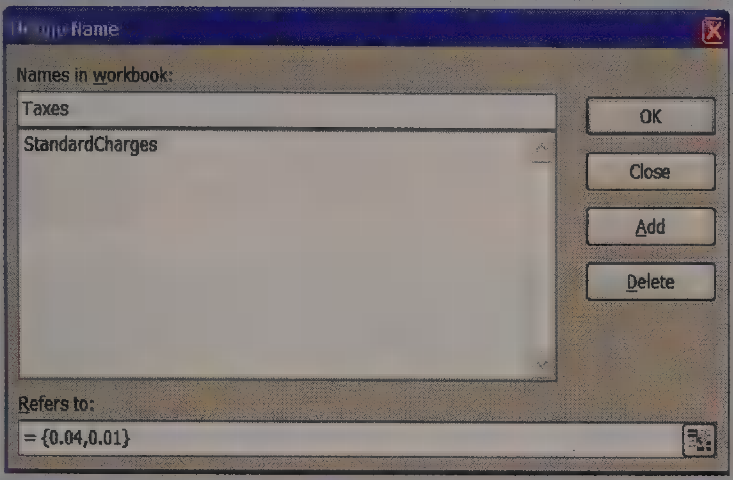
	A	B	C	D
1	**Products**			
2	Product Name	Quantity Sold	Price	Total
3	Chai	73	$18.00	$1,314.00
4	Chang	50	$19.00	$950.00
5	Aniseed Syrup	73	$10.00	$730.00
6	Chef Anton's Cajun Seasoning	76	$22.00	$1,672.00
7	Chef Anton's Gumbo Mix	81	$21.35	$1,729.35
8	Sum			$6,395.35
9	Sum (using arrays)			$6,395.35
10	Sum if greater than the average **price**			$4,351.35
11	Sum if greater than the average **quantity**			$5,445.35
12	Sum if greater than the average price **and** greater than the average quantity			$3,401.35
13	Sum if greater than the average price **or** greater than the average quantity			$6,395.35

Exhibit 4

E3 {=D3:D7*INDEX(StandardCharges,1)}

	A	B	C	D	E	F	G
1	**Products**						
2	Product Name	Quantity Sold	Price	Total	Taxes	Shipping Charge	Total
3	Chai	73	$18.00	$1,314.00	$52.56	$13.14	$1,379.70
4	Chang	50	$19.00	$950.00	$38.00	$9.50	$997.50
5	Aniseed Syrup	73	$10.00	$730.00	$29.20	$7.30	$766.50
6	Chef Anton's Cajun Seasoning	76	$22.00	$1,672.00	$66.88	$16.72	$1,755.60
7	Chef Anton's Gumbo Mix	81	$21.35	$1,729.35	$69.17	$17.29	$1,815.82

Exhibit 5

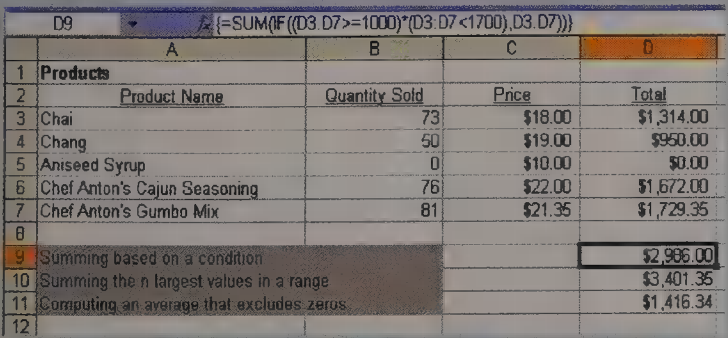


tion is a different type, and that the calculation is not relevant. In many situations we wish to ignore zero values when determining an average. In D11 (Exhibit 6) the array formula =AVERAGE(IF(D3:D7<>0,D3:D7)) averages all nonzero values in the range D3:D7. If you had used the Excel function =AVERAGE(D3:D7), you would have received the value 1,133.07 rather than 1,416.34.

Counting the Number of Differences in Two Ranges

Arrays are exceptionally helpful in ascertaining difference conditions that might have significance. That's especially true when performing internal controls, where consistency and agreement are essential. In Exhibit 7, cell E13 contains an array formula that compares corresponding values in two ranges (D3:D11 and E3:E11) and determines the number of differences that are greater than a specific value. The specific value is in I13 ($2.00); think of this as a materiality threshold on the discrepancy, to separate out those that are trivial or caused by predictable events. If there are no differences between the two ranges, the formula will return 0. When entering the data for this formula, both ranges must be the same

Exhibit 6



D9 {=SUM(IF((D3:D7>=1000)*(D3:D7<1700),D3:D7))}

	A	B	C	D
1	**Products**			
2	Product Name	Quantity Sold	Price	Total
3	Chai	73	$18.00	$1,314.00
4	Chang	50	$19.00	$950.00
5	Aniseed Syrup	0	$10.00	$0.00
6	Chef Anton's Cajun Seasoning	76	$22.00	$1,672.00
7	Chef Anton's Gumbo Mix	81	$21.35	$1,729.35
8				
9	Summing based on a condition			$2,986.00
10	Summing the n largest values in a range			$3,401.35
11	Computing an average that excludes zeros			$1,416.34
12				

size. (Refer to the downloaded file's **Differences** worksheet.)

Identify the Cells

The previous array formula returned the number of differences, but we also may want an itemized listing of those differences. To do that in the range F15:F23 enter this array formula:

=LARGE($E$3:$E$11-$D$3:$D$11,ROW(INDIRECT("1:"&$E$13)))

The formula will return the six cells (see cell E13) that are of interest to us because their hourly rate increased by more than $2. To list in ascending order the six employees whose hourly rate has increased by more than $2 per hour, enter the following formula in E15 and copy it into the range E16:E23:

=INDEX($B$3:$B$11,MATCH(F15,($E$3:$E$11)-($D$3:$D$11),0))

Returning the Location of the Maximum Value in a Range

To return the row number of the maximum hourly rate in the range E3:E11, enter this formula in F26:

=MIN(IF(E3:E11=MAX(E3:E11),ROW(E3:E11),""))

It would return the value 5. To return the address of the maximum value, use this array formula in G26:

=ADDRESS(MIN(IF(E3:E11=MAX(E3:E11),ROW(E3:E11),"")), COLUMN(E3:E11))

The value $E$5 will be returned. Obviously this task can be accomplished by eyeballing the data, but when you're dealing with hundreds of employees, Excel can do the job more effectively.

Determining Whether a Range Contains Valid Values

Many times we need to know whether the values in one range are contained in another. This could be used to uncover fraud based on a "padded" payroll, for example. (Refer to the downloaded file's **Padded Payroll** worksheet.) We could check for that by determining whether every employee receiving a check was also in the master list of employee names. Exhibit 8 demonstrates four array formulas that could do the job—that is, compare payroll names against a master list.

Start by placing this formula in J2:

=ISNA(MATCH(TRUE,ISNA(MATCH($B$2:$B$12,$A$2:$A$10,0)),0))

It will return either TRUE or FALSE. In this case it returns FALSE because there are names in the range B2:B12 receiving payroll checks that are not in the range A2:A10 (the master list of employee names).

Then, in J3 enter this formula:

=SUM(1*ISNA(MATCH($B$2:$B$12,$A$2:$A$10,0)))

It returns the value 4—the number of names receiving a payroll check that are not in the master employee list.

Next, to discover who these people are, enter this formula in the range C2:C12:
=SMALL(IF(ISNA(MATCH($B$2:$B$12,$A$2:$A$10,0)), ROW($B$2:$B$12),""),ROW(INDIRECT("1:"&$J$3)))

The formula returns the array of row numbers of concern.

And then in D2:D12 is the formula:
=INDIRECT(ADDRESS(C2,2))

It returns the names on the payroll checks.

As you can see, CPAs can use array formulas in many ways. The formulas do complex jobs in step-saving ways and are able to cull material that would otherwise consume long hours of searching.❖

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Exhibit 7

E13 fx {=SUM(1*((E3:E11)-(D3:D11)>I13))}

	A	B	C	D	E	F	G	Borders	I
1	**Payroll**								
2	ID	Last Name	First Name	Hourly Rate 1	Hourly Rate 2				
3	1	Davolio	Nancy	$38.04	$42.93				
4	2	Fuller	Andrew	$51.18	$54.22				
5	3	Leverling	Janet	$52.15	$61.25				
6	4	Peacock	Margaret	$34.60	$35.79				
7	5	Buchanan	Steven	$53.39	$55.13				
8	6	Suyama	Michael	$49.84	$57.94				
9	7	King	Robert	$34.14	$42.02				
10	8	Callahan	Laura	$18.49	$20.59				
11	9	Dodsworth	Anne	$35.17	$35.72				
12									
13	Counting the number of differences in two ranges				6	if greater than a specific value			$2.00
14	Identify the 6 cells				Name	Amount			
15					Leverling	$9.10			
16					Suyama	$8.10			
17					King	$7.88			
18					Davolio	$4.89			
19					Fuller	$3.04			
20					Callahan	$2.10			
21					#N/A	#N/A			
22					#N/A	#N/A			
23					#N/A	#N/A			
24									

Exhibit 8

Reply with Changes... End Review...

H13 fx

	A	B	C	D	E	F	G	H	I	J
1	List Employees	Current Payroll	Employees Concern							
2	Davolio	Dodsworth	3	Goldwater		Is every employee name on the master employee list				FALSE
3	Fuller	Goldwater	6	Fogarty		How many names are of concern				4
4	Leverling	Peacock	11	Rita						
5	Peacock	Leverling	12	Katrina						
6	Buchanan	Fogarty	#N/A	#N/A						
7	Suyama	Suyama	#N/A	#N/A						
8	King	King	#N/A	#N/A						
9	Callahan	Callahan	#N/A	#N/A						
10	Dodsworth	Davolio	#N/A	#N/A						
11		Rita	#N/A	#N/A						
12		Katrina	#N/A	#N/A						
13										

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Choose the Right Health Care Account

Stay well—and well-financed—with an array of savings options.

by Bart H. Siegel

Even people in robust health, faced with the variety of tax-favored health spending accounts now available, can find the whirl of regulations and tax considerations dizzying. Three types of employer-sponsored plans offer tax advantages for out-of-pocket or other medical costs: flexible spending arrangements (FSAs), health reimbursement arrangements (HRAs) and health savings accounts (HSAs). Many employees, self-employed people and small business owners will turn to CPAs to sort out each plan's intricacies and help them tailor one to their needs and resources.

The good news: While income tax deductions for health care expenses may be limited by itemization thresholds or the AMT, contributions to health spending accounts generally are excluded from taxable income. Employees may use pretax dollars to make medical-care-related contributions, and self-employed individuals are permitted to take a deduction for health insurance premiums or arrangements having the same effect.

Healthy Outlays

Increased spending for health care in recent years has gobbled up about one-quarter of the growth in the economy. Health-related spending now amounts to more than three times the federal defense budget and twice what the nation devotes to education.

Source: Boston University School of Public Health.

Flexible Spending Arrangements

FSAs are savings accounts funded from pretax earnings that people can use to

High-Deductible Health Plans

A high-deductible health plan (HDHP), commonly referred to as "catastrophic" health insurance, has a deductible of at least $1,100 for individual or $2,200 for family coverage. The annual out-of-pocket deductibles and copayments cannot exceed $5,500 (individual) or $11,000 (family). An HDHP may have "first-dollar coverage," meaning it has no deductible or only a small one, for preventive care. It also may contain higher out-of-pocket limits, copays and coinsurance for out-of-network services.

Young, healthy individuals, who traditionally incur few medical expenses, will find HDHP coverage available, but those with pre-existing medical conditions and those over age 60 or in poor health will probably have difficulty getting underwritten. A physical exam is required as part of the underwriting procedure.

pay qualified medical expenses. Contributions to FSAs (also commonly known as flexible spending accounts and alternately available to cover dependent care costs) typically are made through salary reduction. Distributions to reimburse employees for qualified medical expenses are excluded from their income. Unlike an HSA (discussed below) an FSA need not be accompanied by a high-deductible health plan (HDHP) or other insurance.

FSAs are subject to cafeteria plan regulations, which include a use-it-or-lose-it rule, so an account balance must be spent by the end of each plan year. Starting in 2005, however, the IRS authorized employers to amend their cafeteria plans to allow an optional 2½-month grace period for expenses incurred after the end of the plan year. Therefore, advise your clients to base the amount they elect to have deducted from their pay on an annual budget of likely out-of-pocket expenses. These can include insurance deductibles and copays and even some over-the-counter medications and health supplies.

Because an FSA is considered a group health plan under COBRA and the Health Insurance Portability and Accountability Act of 1996 (HIPAA), though, it is not subject to use-it-or-lose-it in some circumstances. For example, under COBRA continuation-of-benefit rules, recently terminated employees may keep paying into their accounts. Although they must do so with after-tax dollars, the extension allows extra time to spend an accumulated balance that would otherwise be lost. An FSA is also subject to nondiscrimination rules governing self-insured medical reimbursement plans and is a welfare benefit plan subject to ERISA.

Health Reimbursement Arrangements

An HRA, as the name implies, reimburses employees for eligible expenses. As with an FSA, those reimbursements are made from an untaxed account into which the employer pays. Unlike an FSA, the payment is not deducted from the employee's salary but is an additional benefit. It can be accompanied by an HDHP or other insurance plan, but doesn't have to be (see sidebar, "High-Deductible Health Plans"). If it is, the employer can pay the premiums of the HDHP and share the deductible's cost with the employee.

An HRA reimburses only qualified medical expenses and allows the carryover of unused amounts to later years. If the plan is used for nonqualified expenses, all amounts paid become taxable, including prior medical reimbursements.

Health Savings Accounts

An HSA allows your employees and clients to build tax-free assets to pay for medical care. Similar to an IRA, it allows eligible individuals under 65, their family members or employers to make annual tax-deductible contributions. An HSA is paired with an HDHP. The Tax Relief and Health Care Act of 2006 increased contribution limits this year to $2,850 for an individual or $5,650 for families, regardless of the HDHP's deductible amount. The act also authorized rollovers from FSAs and HRAs, as well as a one-time rollover from an IRA. The latter must be a direct trustee-to-trustee transfer, however. Holders may tap the account to pay qualified medical expenses, with the payments not taxed as distributions. Money withdrawn for other purposes by account holders under 65 is subject to a 10% penalty. The account's investments grow tax-free.

EXECUTIVE SUMMARY

- **Health spending accounts offer opportunities** for employees to save and pay for health care with pretax contributions. Three basic types are flexible spending arrangements (FSAs), health reimbursement arrangements (HRAs) and health savings accounts (HSAs).
- **FSAs are typically funded** by pretax payroll deduction and are subject to cafeteria plan regulations, including a "use-it-or-lose-it" rule that prevents carryover of unused amounts to future years, unless an employer has adopted a 2½-month grace period provision. COBRA provisions, however, allow benefits to continue if an employee has a qualifying event such as termination of employment.
- **HRAs may accompany** high-deductible health plan (HDHP) coverage, and the employer and employee may share the deductible's cost. An HRA must be funded solely by the employer and cannot be paid for by salary reduction.
- **HSAs allow tax-free** investment growth, and distributions for medical expenses aren't included in income. HSAs must be paired with an HDHP covering the account owner. Owners can designate a spouse as beneficiary, and the account continues to be treated as an HSA after the death of the account holder and its transfer to the surviving spouse.

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Exhibit 1 Choosing a Plan

Comparing key features of health spending accounts

	Flexible spending arrangement	Health reimbursement arrangement	Health savings account
Initial legislation or regulation	Revenue Act of 1978	U.S. Department of the Treasury revenue ruling 2002-41	Medicare Prescription Drug Act of 2003 Greatly expands the former Medical Savings Accounts.
Date effective	Jan. 1, 1979	June 26, 2002	Jan. 1, 2004
Internal Revenue Code reference	IRC sections 106 and 125	IRC section 105	IRC section 223
Eligibility	All employees except self-employed.	All employees	Individuals under age 65 who have a high-deductible health plan.
Qualified medical expenses	Unreimbursed medical care expenses as defined by IRC section 213, but not premiums for health insurance coverage and long-term care expenses.	Unreimbursed medical care expenses as defined by IRC section 213.	HSA distributions are tax-free if they are used to pay for qualified medical expenses including prescription drugs, qualified long-term care services and long-term care insurance, COBRA coverage, Medicare expenses (but not Medigap), and retiree health expenses for individuals age 65 and older.
Nonqualified medical expenses	Expenses not covered under IRC section 213. Health insurance premiums under a continuation-of-coverage arrangement (such as COBRA). Health insurance premiums when receiving unemployment compensation. Qualified long-term care insurance premiums.	Expenses not covered under IRC section 213.	Distributions made for any other purpose.
Must be covered by a health insurance plan	No	No	Yes
Contributor	Employee, employer or both	Employer	Tax-advantaged contributions can be made in three ways: (1) the individual and family members can make tax-deductible contributions even if the individual does not itemize deductions, (2) the individual's employer can make contributions that are not taxed to either the employer or the employee and (3) employers with cafeteria plans can allow employees to contribute untaxed salary through a salary reduction plan.
Contribution limits	No statutory limit; limits may be set by employer.	No statutory limit; limits may be set by employer.	The maximum annual contribution is $2,850 for self-only policies and $5,650 for family policies (indexed annually). Individuals age 55 to 65 may make additional "catch-up" contributions of up to $800 in 2007, increasing to $1,000 annually in 2009 and thereafter. A married couple can make two catch-up contributions as long as both spouses are at least 55.
Funds carried over to next year	No, except plans may offer a 2½-month grace period.	Yes	Yes
Portability	Account cannot be maintained if the employee is no longer working for the employer, except under COBRA continuation-of-benefit provisions.	At employer discretion	Amounts contributed to an HSA belong to individuals and are completely portable. Money not spent stays in the account and gains interest tax-free, just like an IRA. Unused amounts remain available for later years.

Source: Division of Compensation [illegible] Analysis and Planning, Bureau of Labor Statistics; Department [illegible] Affairs

Account holders under age 65 must be covered under an HDHP but no other health policy providing any of the same benefits.

Your clients can use an HSA to save for anticipated big-ticket services, such as orthodontics, which may not be covered fully, or even at all, by other health plans. But it may be to your clients' advantage to instead pay for medical bills out of pocket and let their accounts' investments appreciate. The account continues to be treated as an HSA after the death of the holder and its transfer to a surviving spouse, provided the surviving spouse is the designated beneficiary.

"You're under no obligation to pay your medical bill out of the HSA account," says Martha Priddy Patterson, a director with Deloitte & Touche. "If you can afford not to, it's smart."

Here's an additional side benefit to your clients: Because they are paying for most of their health care out of savings, they're likely to reduce costs by using medical care more judiciously.

Clients can sign up for HSAs with banks, credit unions, insurance companies and other approved companies. As with IRA contributions, post-year-end contributions to HSAs made by the due date for the tax return for the prior year will be deductible. Many states also exempt HSA contributions from state income tax.

Your client owns and controls the money in an HSA, including deciding how it is invested, except that it may not be invested in life insurance. But here are some restrictions to watch out for:

- Contributions over the limits are not deductible, and IRC section 4973 imposes a 6% excise tax on the excess funds.
- Excess contributions by an employer generate taxable income to the employee.
- People may withdraw funds at any time for nonmedical expenditures, but distributions not used for medical expenses must be included in income and are subject to a 10% penalty. When an individual becomes eligible for Medicare, dies or becomes disabled, however, the funds may be used for any purpose without incurring the penalty (although withdrawals for nonmedical purposes are taxed as ordinary income).

An HSA with an HDHP can offer significant savings over traditional insurance, especially if you don't have—or lose—group coverage. For example, my wife left a company that provided our coverage. We received a notice, as a result of COBRA, that we had the right to continue coverage for a limited period as long as we assumed the employer contribution of the cost. Talk about sticker shock: Our monthly premiums rose from about $300 a month to more than $1,200. Most individual policies with comparable benefits were similarly expensive. Then I priced HDHPs with a health savings account.

First, I was pleased to find that as my annual deductible rose to $10,000, my monthly premium fell to $250 a month. After the deductible, the plan provided almost 100% coverage. So compared with paying $14,400 annually in premiums, plus copayments, I found the HSA to be the obvious choice, before I even started analyzing the significant tax benefits.

Next, I found that doctors often lower their fees when they know you are paying out of pocket. Prescription costs, although higher than health insurance copayments, were much lower than we expected. An HDHP may have contracted rates with medical providers like conventional insurance plans, which also reduces out-of-pocket costs.

Especially with recent changes expanding the flexibility of HSAs, the time has never been better for people to take charge of financing their health care and take advantage of the range of options. That's where CPAs, as advisers in this increasingly important aspect of financial planning, can help point clients in the right direction, at the crossroads of health and wealth. ❖

AICPA RESOURCES

CPE

- *Personal Financial Planning: Group Insurance and Employee Benefits*, by Carla Gordon. Covers menu-type employee benefit programs such as cafeteria plans and FSAs. **www.cpa2biz.com/OnlineProducts/CPExpress/Consulting+Services/IB_GTL.htm.**
- *Understanding the Mechanics of Health Savings Accounts*, by Gary S. Lesser, Susan D. Diehl and Christine L. Keller (# 180311JA).

Personal Financial Planning Center
Articles on all the health spending accounts described in this article are available to AICPA PFP Section members at **pfp.aicpa.org**.

Publication
The Adviser's Guide to Health Spending Accounts, by Gary S. Lesser, Christine L. Keller and Susan D. Diehl (# 091020JA).

For more information or to make a purchase, go to **www.cpa2biz.com** or call the Institute at 888-777-7077.

OTHER RESOURCES

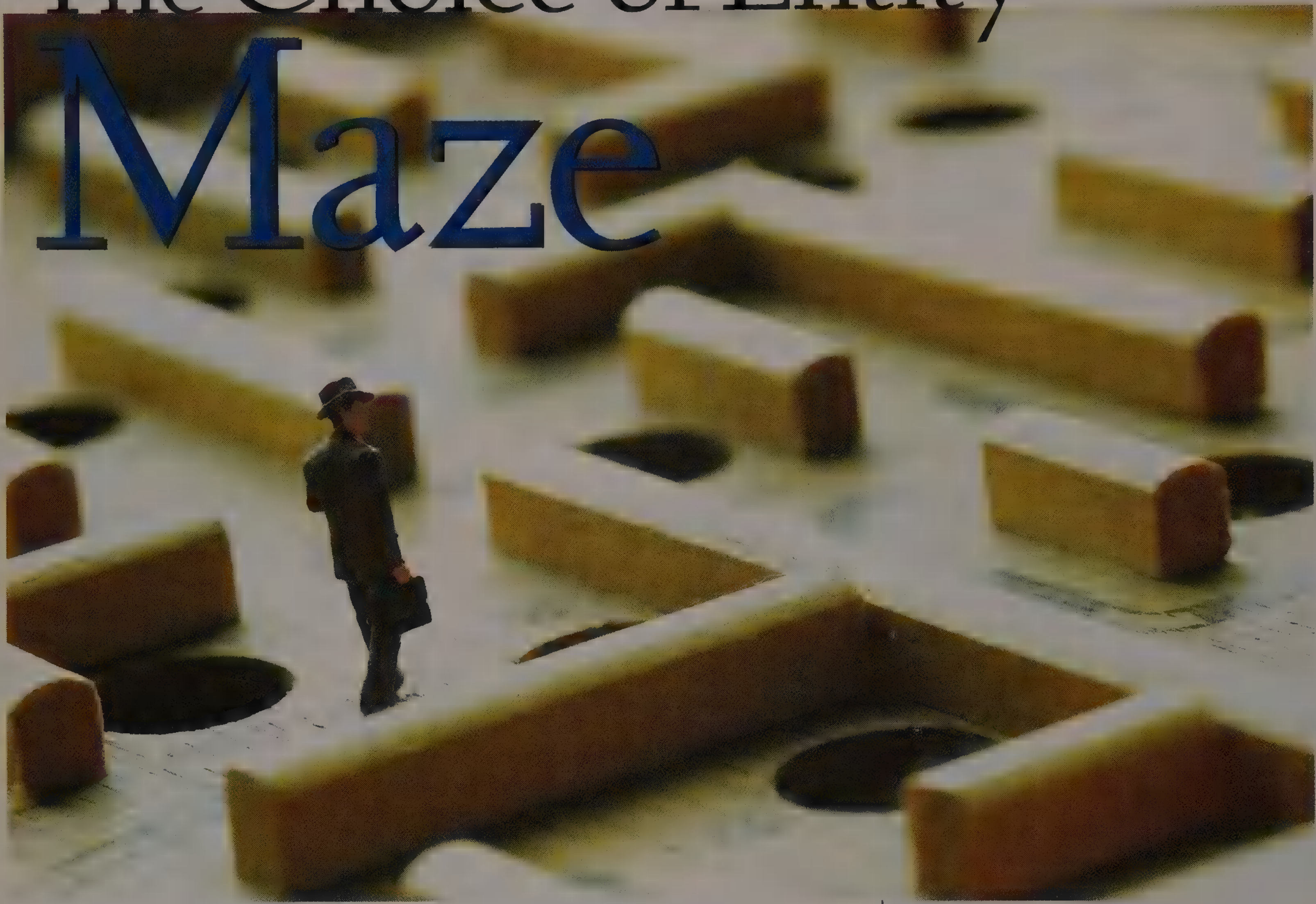
IRS Publication 969, *Health Savings Accounts and Other Tax-Favored Health Plans*, **www.irs.gov/publications/p969**.

» Practical Tips

▶ Flexible spending arrangements' use-it-or-lose-it feature pertains not just to the end of a calendar year (and possible $2^1/_2$-month grace period) but to termination of employment with a company. If employees know they're going to leave a job where they have an FSA, they can review their contributions and expenditures since the beginning of the year and make qualifying purchases from any unspent balance. But they'll have to do it before they leave the job.

▶ If an HSA holder's spouse is the account's designated beneficiary, following the death of the account holder and the transfer of interest, the account continues to be treated as an HSA, with the spouse as the account holder. If the designated beneficiary is not the account holder's spouse—for example, the estate or another individual—the account ceases to be an HSA as of the date of death, and the fair market value of the funds is includible in the beneficiary's gross income.

The Choice-of-Entity Maze



Tax and nontax issues make for complicated decisions.

by Gregory A. Porcaro

Selecting the right entity for its operations is an important issue for every business—and every CPA who's called on to help clients decide. Whether a corporation or a limited liability company (LLC) is the better choice is not always obvious. The selection involves numerous legal and tax issues and should involve the client's or employer's attorney. CPAs must consider all the facts and alternatives and, above all, understand the client's objectives. This article highlights key differences between types of corporations and LLCs that are treated as a partnership for tax purposes.

THE RIGHT CHOICE

Fortunately, the choice-of-entity question does not have to be answered absolutely. The majority of closely held businesses engage in more than one business activity, and it's possible to use a different entity for each.

Owners of closely held businesses often ignore the structural barriers between entities (and sometimes between their business and personal activities); they tend to treat all the businesses as one entity. This can have significant negative repercussions, particularly for limited liability protection and income taxes.

Issues CPAs need to consider when helping clients choose an entity, listed in Exhibit 1, can be organized into four

Exhibit 1 Selected Issues Affecting Choice of Entity

Tax issues	Nontax issues
Sale of business/liquidation	Limited liability protection
Tax rate exposure	Capital structure
Use of losses	Stockholder and buy-sell agreements
Compensation package	Type of business/investment activity
Complexity	State law
State tax issues	

categories: capitalization, compensation, profit and loss allocation, and distributions.

CAPITALIZATION

For a corporation, the contribution of property solely in exchange for at least 80% of the corporation's stock generally is tax-free under IRC section 351. From the standpoint of capital structure, C corporations and LLCs offer more flexibility than S corporations, which are subject to statutory restrictions on their classes of stock and the number and type of stockholders. Depending on the client's objectives and goals, these restrictions can have a critical effect on the choice-of-entity decision. For example, if the organizer of a new business plans to raise equity capital that provides a fixed rate of return and limited liquidation rights, an S corporation would not be appropriate.

The basis of property contributed to a corporation under section 351 is equal to the contributor's basis at the time, plus any gain recognized from excess liabilities or the receipt of property other than stock (such as a note). In certain situations, the corporation's basis can be limited to the property's fair market value. If the assets are encumbered by liabilities that exceed their basis, the contributor must recognize gain equivalent to that excess under IRC section 357(c). This gain recognition may be avoided if the contributing stockholders also contribute a bona fide note (with a fair market value equal to the difference) to the corporation. The important point is that the issue must be addressed when the initial capitalization takes place.

Sometimes, to attract or retain a key person, a corporation must issue stock in exchange for services. That normally results in taxable income to the recipient equal to the stock's fair market value—unless the stock is subject to a substantial risk of forfeiture, as described by IRC section 83(a)(1). If IRC section 351 applies, it may be possible to avoid this result if the recipient exchanges some form of property for the stock, such as a customer list or other intangible asset. In general, revenue procedures 2001-43 and 93-27 state that an exchange for a profit-only interest in an LLC does not give rise to taxable income. However, in May 2005, the IRS issued proposed regulations that treat the exchange of a profit-only interest for services similarly to an exchange of corporate stock—see proposed Treasury Regulation 1.761-1. And for S corporations, the basis of the assets contributed becomes the basis of the contributor's stock for purposes of using losses that may pass through in the future.

EXECUTIVE SUMMARY

■ **When advising clients on** the choice of business entity, CPAs should consider the advantages and disadvantages of each type. If more than one entity is involved, CPAs should also determine whether clients can deal with the complexity of the resulting structure.

■ **The many issues to consider** can be organized into four categories: capitalization, compensation, allocation of profits and losses, and distributions.

■ **From the standpoint** of capital structure, C corporations and LLCs offer more flexibility than S corporations, which are subject to statutory restrictions.

■ **Compensation within corporations** is affected by the number of shareholders and their involvement in the corporation's business. Consider whether there are one or multiple shareholders, whether the shareholders each own the same amount of stock, whether they perform services and how fringe benefit plans are set up.

■ **For both C and S corporations,** reasonableness of compensation is an issue. For C corporations, the question is whether a shareholder/employee's salary is too high relative to any dividends paid. For S corporations, the question is whether the salary is too low in relation to distributions.

■ **The ability to use losses** is often critical in the choice of a business structure. In general, because third-party debt may create basis for members, LLCs provide better opportunities for passing through losses than do S corporations for their shareholders.

■ **The tax treatment of distributions** may vary, depending on the type of entity making the distribution, the type of entity receiving it and the type of property being distributed. Property distributed from a C corporation is generally taxed to the recipients; distributions to S shareholders are subject to rules that follow a specified order. For LLCs, cash and property distributions are generally tax-free (to the extent of basis), but there are many exceptions.

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Exhibit 2 Factors in Determining Reasonable Compensation

C corporations	S corporations
Compensation paid in proportion to stock ownership	Services performed in relation to salary
Dividend history	Number of employees
Corporation's capital structure	Degree of control over corporation
Year-end increases in salary	Undocumented loans receivable
Existence of employment agreement	Existence of employment agreement
Statistical reasonableness of compensation based on the company's sales	Compensation level of other employees
Industry guidelines	Industry guidelines
Loan covenants	Loan covenants

In many situations, capital is contributed with a loan to the corporation. When advising organizers whether to receive stock or debt, CPAs should consider:

- Will there be more than one stockholder?
- Will all the stockholders be equal?
- Will stockholders contribute property of equal value?
- Will the entity be an S corporation or a C corporation?
- Will stockholder distributions be made?

The answers to the first three questions revolve around the difference in rights between a stockholder and a creditor. For example, if three individuals intend to be equal stockholders but one of them contributes $100,000 more in cash than the others, that stockholder should receive a note for the excess, possibly secured by corporate assets. The decision to make an S corporation election does not change this conclusion.

Because of the S corporation basis rules under IRC section 1366, the debt-vs.-equity question carries important tax ramifications. S corporation stockholders can use debt basis for deducting losses, but subsequent repayment of the debt results in the recognition of taxable income, which in many cases comes as a surprise. On the other hand, C corporation stockholders are better served by holding debt, because generally they can receive nontaxable loan payments, regardless of the corporation's profits or losses. In general, barring any legal issues, S corporation stockholders should choose to receive stock in exchange for capital.

Dividend distributions to stockholders of a C corporation represent after-tax corporate earnings and are subject to tax at the stockholder level (generally at a 15% rate). A C corporation may be the appropriate entity in situations involving a complex capital structure designed to provide investors with a specified rate of return. If preferred stock is issued, the rate of return will not include appreciation in the value of the company, unless it is convertible into common stock. In general, distributions to S corporation stockholders are not taxable. However, S corporation distributions must be made on a pro rata basis to all stockholders, including liquidating distributions (see "Distributions" below).

COMPENSATION

How compensation is structured can have both tax and nontax effects on the choice of entity. Members of an LLC cannot be treated as employees. Therefore, to design a compensation plan other than one based solely on ownership, an LLC's operating agreement must provide for guaranteed payments. (Other issues regarding LLC members' exposure to self-employment tax on their share of allocated earnings are still evolving and beyond the scope of this article.) Corporate stockholders can be treated and compensated as employees and are subject to payroll tax withholding. In a corporate environment, many nontaxable fringe benefits (such as health insurance and retirement plans) can be offered only to employees; therefore, it is critical that stockholder/employees' compensation is properly reported on form W-2.

At the most fundamental level, the structure of compensation is affected by the number of stockholders and their involvement in the corporation's business. Typically, a sole-stockholder C corporation structures compensation to reduce taxable income on the corporate level, thereby reducing the stockholder's future exposure to double taxation. This is true despite the fact that qualifying dividends are currently subject to a 15% federal tax rate.

But a sole stockholder of an S corporation may structure compensation to increase corporate taxable income that will pass through to him or her, thereby reducing exposure to Social Security taxes. Due in part to a Treasury Inspector General Report issued in 2002, the IRS has increased its focus on S corporation compensation vs. distributions to sharehold-

Exhibit 3 LLC Distributions—Exceptions to the General Rule

Distributions of marketable securities–IRC section 731(c).
Disproportionate distribution of unrealized receivables or appreciated inventory–IRC section 751.
Distributions of property within two years of a contribution to the LLC –Treasury Regulation 1.707-3(c)(1).
Noncash distributions to a member within seven years of contributions –IRC section 737.
Contributed property distributed to another member within seven years –IRC section 704(c).

ers. Overall, a C or S corporation provides a familiar compensation structure.

In a multistockholder corporate environment, the following issues affect compensation vs. distribution:

■ Do all stockholders own the same amount of stock?

■ Are all stockholders performing services to the corporation?

■ How are fringe benefit plans designed?

C corporations offer more flexibility, such as a deferred compensation benefit and stock option plan. In general, as a pass-through entity, an S corporation cannot offer deferred compensation; the fact that the salary is not currently deductible increases the amount of income that flows through to shareholders. S corporations can offer stock options, provided they do not create a second class of stock.

In both C and S corporations, CPAs also must be concerned about the reasonableness of compensation. For C corporations, the question is whether the stockholder/employee's salary is too high in relation to any dividends paid. For S corporations, the question is whether the stockholder/employee's salary is too low in relation to distributions. Exhibit 2 lists relevant factors for each type of entity.

ALLOCATION OF PROFITS AND LOSSES

Another decision is whether to create a flow-through entity such as an S corporation or LLC. C corporations are subject to corporate tax rates on the first $75,000 of taxable income, which are lower than an individual would pay with a flow-through entity. Individuals considering organizing a C corporation, however, should be aware that:

■ Personal service corporations, such as medical practices, are subject to a flat 35% tax rate.

■ Multiple C corporations, commonly owned by up to five persons who own more than 50% of the corporations' voting stock and value, must allocate the C corporation tax brackets among the corporations.

■ Except for personal service and farming businesses, C corporations with gross receipts exceeding $5 million cannot use the cash-basis method of accounting.

An S corporation's profit and loss is allocated to its stockholders on a per-share, per-day basis, based on stock ownership. In general, LLCs offer greater flexibility in allocating profits and losses among members, provided the allocation has substantial economic effect (as defined in IRC section 704). This is a complex topic, but basically, profits and losses must be allocated in a way that mirrors the economic risk of each LLC member.

The ability to use losses generated by a pass-through entity often is a critical consideration when choosing a structure. In general, S corporations do not offer as great an opportunity to use losses as LLCs.

Both S corporations and LLCs limit interestholders' ability to use losses that pass through to their basis in the entity. CPAs must help clients or employers properly document their basis in either form of entity. For example, if an individual has a stock basis of $50,000 and allocable losses of $75,000 in an S corporation or LLC, only $50,000 of losses can be used to offset other income, assuming the at-risk (IRC section 465) and passive activity loss (IRC section 469) rules do not apply.

The distinction between S corporations and LLCs turns on the definition of basis. In an S corporation, basis is defined as capital in the form of stock and direct stockholder loans. Third-party debts, personally guaranteed or not, do not create basis. But many forms of third-party debt do create basis for an LLC member. If, in the example in the preceding paragraph, the entity borrowed $25,000 from a personally guaranteed business line of credit, an S corporation stockholder could still deduct only $50,000 of losses. But an LLC member could deduct the entire $75,000 ➤

Practical Tips

▶ If an entity wishes to offer a deferred compensation benefit and stock option plan, consider a C corporation.

▶ In a common transaction involving the purchase of real estate using personally guaranteed debt, recommend the client form an LLC.

▶ A well-drafted stockholder agreement can eliminate or at least mitigate the problem that arises when income is allocated to a stockholder and reported on a schedule K-1 without a corresponding distribution of cash or other property.

loss, because his or her basis would include the personally guaranteed debt.

Distributions

The entity's stockholder or operating agreement should specify the amount and timing of distributions of property or cash. This is particularly important to a minority interestholder. The tax treatment of a nonliquidating distribution is determined by the type of entity making the distribution, the type of entity receiving it and the type of property being distributed. Property distributions from either C or S corporations trigger a recognized corporate-level gain to the extent the fair market value of the property distributed exceeds its basis.

The value of the property distributed from a C corporation is included in the gross income of the recipients (possibly subject to a 15% tax rate) if the 90-day holding period for individuals and the dividends-received deduction requirements for corporations are met. This inflexible structure is one of the principal reasons corporations generally are considered the wrong type of entity for owning appreciable property, such as real estate.

The income-tax treatment of S corporation distributions of cash or property (at fair market value) to shareholders, on the other hand, follows a specified order. First, distributions are not taxable to the extent of the corporation's undistributed earnings (its accumulated adjusted account); then they are considered a return of capital, to the extent of the recipient's basis in the S corporation stock; and finally, any excess is treated as a capital gain.

At first glance, the ability to make nontaxable distributions appears attractive. However, CPAs must caution clients that their exposure to taxation is based on their allocable share of profits. It is possible to have income allocated to a stockholder and reported on a schedule K-1 without a corresponding distribution of cash or other property. This problem can be eliminated (or at least mitigated) with a well-drafted stockholder agreement.

The distribution rules for LLCs, meanwhile, are deceptively simple. In general, cash and property distributions are tax-free to the extent of the member's basis in the LLC. However, there are numerous exceptions, as shown in Exhibit 3, depending on factors such as the type of property being distributed, to whom it is being distributed, when it was contributed to the LLC and by whom. In addition, subchapter K, which governs the tax treatment of LLCs, provides various rules for determining the basis of distributed property as well as the property retained by the LLC.

One significant advantage LLC/partnerships enjoy over corporations is the ability to adjust the entity's basis in assets retained if a gain or loss is recognized due to a distribution from the LLC (IRC section 734) or a sale of an LLC interest (IRC section 743). A partnership can make this election, which applies to all subsequent transactions and cannot be revoked without the IRS's consent. The election is provided by section 754. However, the American Jobs Creation Act of 2004 requires a mandatory basis adjustment if the built-in loss amount exceeds $250,000.

A Path to the Future

When CPAs are helping their clients or employers through the maze of entity selection options, they must consider numerous issues. Some involve what the client is planning to do in the immediate future; others require looking into the distant future. This decision also may be dramatically affected by future changes in business and tax law. ❖

AICPA RESOURCES

CPE

- CPExpress: *Choice of Entities: Entity Formation Issues*, by James R. Hamill (# HBJ).
- CPExpress: *Choice of Entities: General Considerations*, by James R. Hamill (# HBI).
- CPExpress: *Individual Tax Planning: Choice of Business Entity*, by William Bischoff (# GHH).
- *Guide to Limited Liability Companies*, by CCH Tax Law Editors (# CC53933JA).
- *S, C, Partnership or LLC? Using a Business Form to Solve Your Client's Tax and Business Problems*, by James R. Hamill (# 735536JA).

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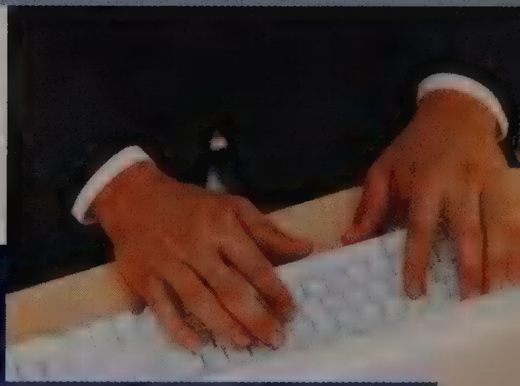

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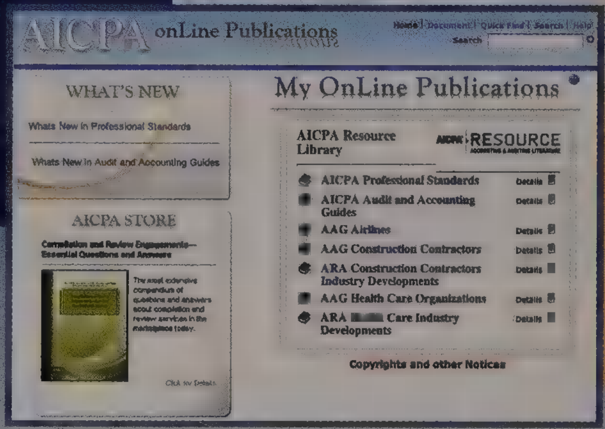

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PRACTITIONERS NEED TO CONSIDER THE RISKS

CPAs Volunteering at Nonprofits

Because of their business and financial acumen, CPAs are often asked to serve as board members or officers of nonprofit organizations. While this can be a satisfying experience, they should be aware of the numerous requirements applicable to nonprofits. Failure to adhere to these rules can subject officers and board members to penalties, and may even jeopardize an organization's tax exemption.

TAX-EXEMPT STATUS

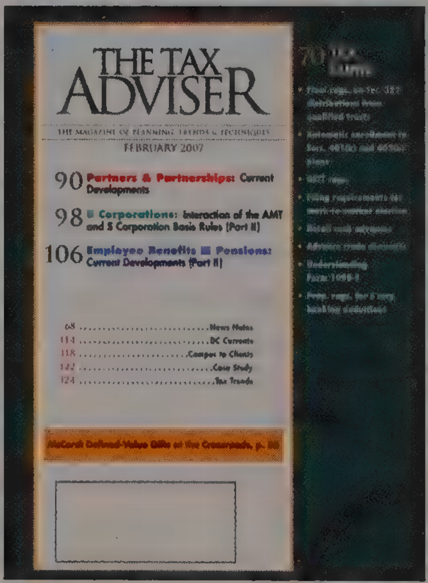
Numerous nonprofits qualify for an exemption from federal income taxes; many are also eligible to receive deductible contributions. This status is crucial. If lost, the nonprofit's income would be subject to federal income tax, donors would be unable to deduct contributions (making fundraising difficult, if not impossible) and state and local tax exemptions (especially for property tax) would be unavailable.

A CPA looking to work with a nonprofit should take special care to assess the organization's records (articles of incorporation, bylaws, etc.) and operations, to ensure that the entity has properly established its exempt status and continues to maintain it.

ESTABLISHING EXEMPT STATUS

A nonprofit's articles of organization must limit its activities to *tax-exempt purposes*. It cannot be empowered to carry out any substantial nonexempt activities.

The CPA should check the entity's exempt status paperwork. Application for exemption is generally made by filing IRS form 1023; some small nonprofits (and churches) need not file this form.



The practitioner should also review the IRS determination letter the organization received. Often, the service will grant public charity status under an advance ruling, in which the organization will be deemed a public charity for five years; at the end of this period, it will need to show that it has truly been publicly supported.

MAINTAINING EXEMPT STATUS

In addition to being created properly, an entity must be operated exclusively in accordance with its exempt purposes. Although it must be primarily engaged in its exempt mission, insubstantial other activities should not jeopardize exempt status.

No private inurement. No part of the organization's net earnings (or operations) can accrue to the benefit of private shareholders or individuals. This area poses the greatest risk of inadvertent noncompliance.

Technically, *any* inurement, regardless of amount, can trigger the loss of exempt status. However, because such a punishment is drastic, intermediate sanctions (excise taxes) were created to penalize those specifically responsible, yet allow the organization to keep exempt status.

These sanctions apply to excess benefits provided to disqualified persons. Generally, these are persons in a position to exert substantial influence over the organization. Excess benefits are economic benefits provided by a nonprofit to a disqualified person, in excess of the value of the services provided by such person. In addition, organization managers who knowingly participate in providing a disqualified person with an excess benefit may also be subject to sanction.

For a discussion of the tax risks and issues facing nonprofits, see "A Tax Primer for CPAs Volunteering at Nonprofit Organizations," by Mark Cowan, J.D., CPA, and Denise English, Ph.D., CPA, CIA, in the March 2007 issue of *The Tax Adviser*.

—Lesli S. Laffie, editor
The Tax Adviser

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TAX MATTERS

TAX BRIEF

ON THE LINE FOR A PHONE TAX REFUND?

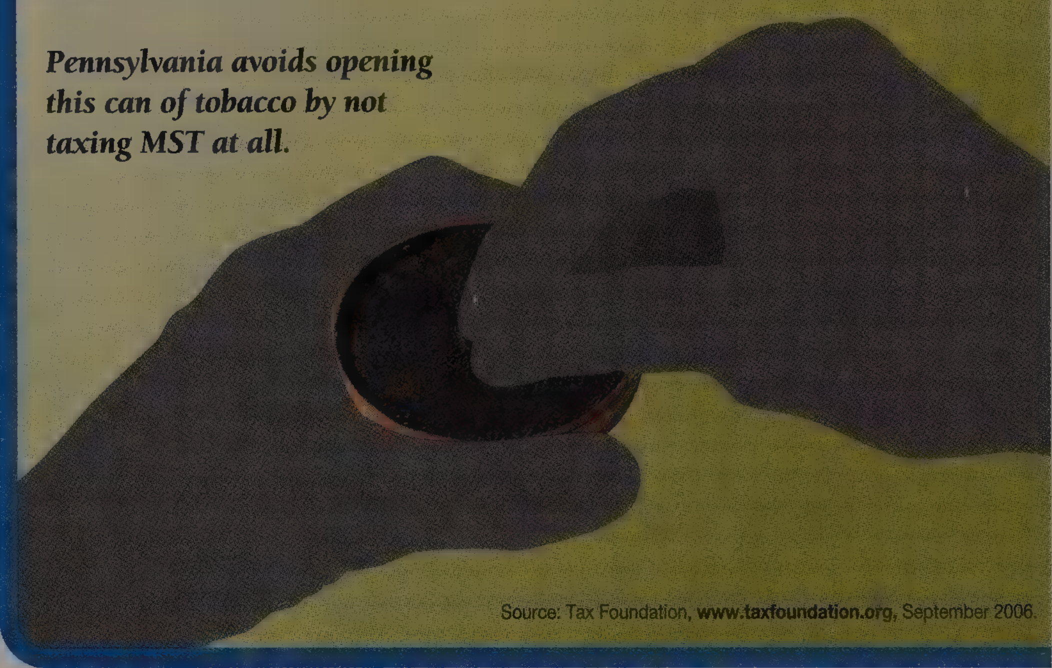
Are your clients using the standard formula for their refund of federal excise tax (FET) on long-distance phone service? The IRS made it easy: Just compare the FET rates on phone bills for April and September 2006—before and after phone companies quit collecting the tax on anything other than local service—and multiply the difference by the total spent on phone bills for the 41 months the refund covers.

Maybe that's a little too easy, say consultants offering "FET recovery" services. For many enterprises, the actual excise tax paid is more than double the amount the formula allows, says John Manickam of Wingspread Business Support Services of Raleigh, N.C. (**www.wingspreadbss.com**). Details are available in *The Handbook for Telecommunication Federal Excise Tax Refund*, by Manickam and Michael S. Plude, CPA, which is available for $65.99 as a book or download from **www.fet-refundhandbook.com**. Telecommunications expense management companies also offer the service. Although the refund can be claimed only on 2006 returns, businesses that used the formula may find it worthwhile to file an amended return with actual tax paid, Manickam said.

Price Trumps Unit

Of the 49 states that imposed a tax on smokeless, moist snuff tobacco (MST), nine of them taxed per unit, while the rest based their taxes on sales price.

Pennsylvania avoids opening this can of tobacco by not taxing MST at all.



Source: Tax Foundation, **www.taxfoundation.org**, September 2006.

TAX CASE

LOAN PREMIUM NOT LIABILITY

Many taxpayers have been able to reduce their taxes in transactions involving contingent liabilities, leading Congress to change subchapter C and the Treasury Department to change the regulations under IRC section 752. In July 2006, a district court reviewed the definition of a liability and Treasury's ability to make regulations retroactive and ruled in favor of the taxpayer.

St. Croix Ventures and Rogue Ventures, single-member LLCs, each borrowed $41.7 million from a bank at 17.97% interest. They each received the principal and a $25 million "loan premium" in exchange for the above-market interest rate. The loans required interest for seven years and repayment of principal at the end of the period. The LLCs agreed to pay a declining penalty if they repaid the loans early. Each LLC invested its total amount, $66.7 million, in Klamath LLC and Kinabalu LLC, respectively, for 90% partnership interests. The partnerships assumed the debt. Several months later, St. Croix and Rogue withdrew from the partnerships. The partnerships repaid the debt and distributed cash to the LLCs. The IRS classified the $25 million loan premium as a liability; the taxpayer disagreed.

Result. The court first decided whether the loan premium was a liability for purposes of IRC section 752. At the time of this transaction, in 2000, the regulation did not define a liability. Prior cases—*Helmer v. Commissioner* and *Long v. Commissioner*—held that contingent liabilities are not liabilities for purposes of section 752. A contingent liability is one that is not fixed; it does not become a liability until it becomes fixed or liquidated. Since the loan premium was not repayable unless the loan was prepaid, and that event was not certain to occur, the loan premium was contingent and not a liability.

The government also argued the contingent amounts had to be classified as liabilities to maintain the equality of inside and outside basis. The court

acknowledged that much of partnership taxation is designed to maintain this equality. However, it does not always exist. In fact, the government has argued against equality when it was in its interest to do so. Therefore, the court rejected the need for equality when a disparity served the taxpayer's interest.

The final issue was whether Treasury Regulation section 1.752-6, issued June 24, 2003, could be applied retroactively to affect the outcome of the case. Regulations are not generally applied retroactively, but they can be. Before examining the general rules for retroactive regulations, the court said the level of deference accorded an interpretive regulation was less than for a statutory regulation. Since the court ruled the regulation was interpretive, it considered the general rules for retroactive regulations. The court listed four items that affected the decision: (1) whether the taxpayer was reasonable in relying on prior law or policy; (2) whether Congress implicitly approved the prior law by re-enactment of relevant code sections; (3) whether retroactive application would cause equal taxpayers to be taxed differently; and (4) whether retroactive application would result in a harsh outcome. The court concluded that factors 1, 2 and 4 favored the taxpayer and 3 was neutral and denied retroactive application of the regulation.

In May 2005, the Treasury Department issued final regulation section 1.752-7, which approaches contingent obligations differently than the regulation in question in this case and the approach taken for corporate taxpayers. This case is still relevant for the definition of liabilities and the retroactivity of regulations.

■ *Klamath Strategic Investment Fund LLC v. United States*, 440 F. Supp.2d 608; 98 AFTR2d 2006-5495 (DC Tex., 2006).

Prepared by Edward J. Schnee, CPA, PhD, *Hugh Culverhouse Professor of Accounting and director, MTA program, Culverhouse School of Accountancy, University of Alabama, Tuscaloosa.*

TAX CASE

PERSONAL LOAN GUARANTEE NOT BASIS

Losses from an S corporation flow through to its shareholders, who can deduct them on their individual tax returns as long as they have sufficient basis to absorb them. Economic outlays such as capital contributions and loans by a shareholder to an S corporation will increase a shareholder's basis. Generally, loan guarantees, pledges of collateral and other forms of indirect borrowing are not considered economic outlays. The Eleventh Circuit Court of Appeals created an exception in *Selfe v. U.S.*, 778 F.2d 769, in which a taxpayer borrowed money and later loaned that money to her newly formed S corporation. The corporation then assumed her liability for the loan, but the bank required the taxpayer to personally guarantee its repayment. The court permitted a basis increase because of the loan guarantee, since the substance of the transaction showed she was the primary obligator on the loan.

Last year, the Sixth Circuit refused to apply the *Selfe* exception to a case in which the taxpayer cosigned on the loan but the bank never sought payment from him.

William Maloof was the sole shareholder of Level Propane, Petroleum & Gases Co., which borrowed $4 million from a bank. Maloof personally guaranteed the loans by pledging all of his stock in it and other S corporations and a $1 million insurance policy on his life. Level Propane defaulted on the loan and was forced into bankruptcy, but the bank did not demand payment. From 1990 to 2000, Level Propane sustained large losses. Maloof increased his basis by $4 million because of the loan guarantee and then deducted the losses on his individual return. The IRS took the position that no increase in basis was warranted, disallowed the losses and assessed a tax deficiency against him. Maloof petitioned the Tax Court.

Maloof argued that his personal guarantee of the loan and the pledging of his stock and insurance policy constituted economic outlays that increased his basis. The Tax Court rejected this argument, stating the bank never sought his personal assets for repayment of the loan. The taxpayer also argued he had an economic outlay because he incurred a "cost" when he lost control of the corporation. No evidence was presented supporting any loss of control, nor was any evidence offered that measured a cost related to that loss. Finally, the taxpayer argued that, in substance, he had borrowed the money and in turn transferred it to the corporation and that the holding in *Selfe* should be followed. The court ruled the *Selfe* holding did not apply because Maloof never personally borrowed any money and the bank never sought any payments from him (see "Tax Matters," *JofA*, Mar.06, pages 78–79). Maloof appealed to the Sixth Circuit.

Result. For the IRS. The appeals court said Maloof's basis could be increased if the corporation was indebted to him or if he had incurred a cost evidenced by an

Credit Counselors Fail

Over the past two years, the IRS completed audits of 41 credit counseling agencies representing more than 40% of the revenue in their industry—and found that every one failed to provide the level of public benefit required to qualify for tax exemption.

Source: IRS, www.irs.gov.

economic outlay. The loan agreement clearly showed the corporation as the borrower, and the corporation would be indebted to him only if he used personal assets to pay the corporate loan. Even though the taxpayer cosigned the loan, the bank never sought his assets for repayment. Based on this, the court concluded Maloof never incurred any type of economic outlay.

This decision marks another defeat for taxpayers attempting to increase their S corporation's stock basis with a loan guarantee. It should also be noted that if the taxpayer had shown that the loan was his, the interest payments made by the corporation to the bank on his behalf would be constructive dividends. He still would have had some additional tax liability.

■ *William H. Maloof v. Commissioner*, 456 F.3d 645.

Prepared by Charles J. Reichert, CPA, *professor of accounting, University of Wisconsin, Superior.*

TAX CASE

FULL DEDUCTION ON MEAL REIMBURSEMENTS

Under IRC section 274(n), employers generally may deduct only half their reimbursements to employees for meals and entertainment. But employee-leaseback arrangements—notably in the trucking industry—have mapped a route through the section's several exceptions.

Many smaller trucking carriers use a professional employer organization (PEO) to reduce their costs. One PEO, Transport Labor Contract/Leasing (TLC), in 2004 had 5,563 driver-employees leased to 453 trucking company clients. TLC paid per diem reimbursements to its drivers and billed its trucking company clients for these amounts. In 2004 the Tax Court said TLC was subject to the 50% limitation because it, rather than the trucking companies, was the "common-law employer." Although the trucking companies made recommendations on which drivers to hire, the Tax Court noted that TLC screened and eliminated some candidates and retained the right to lease a driver to any of its trucking clients. TLC appealed to the Eighth Circuit.

Result. For the taxpayer. If the reimbursement is wages, the 50% limitation is on the employee, but the limit shifts to the employer for expense reimbursements. However, an employer can escape the limit if the payments qualify under the IRC section 274(e)(3) exception, because they are "paid or received by one person…under a reimbursement or other expense allowance arrangement with another person other than an employer." The appeals court said TLC qualified for this exception because it was the employer performing services for a "person other than an employer" under a proper reimbursement arrangement.

The Eighth Circuit also said it did not disagree with the Tax Court's decision in *Beech Trucking*, 118 T.C. 428 (2002), in which the Tax Court applied the limitation to a trucking company that was the common-law employer. But when a PEO is the employer, it should qualify for the exception if it can substantiate a "reimbursement or other expense allowance arrangement" as defined by 1.62-2(c) through (f) of the Treasury Regulations. The trucking company, not the PEO, actually bore the expense and thus should be subject to the limitation, the appeals court said.

If the PEO is the common-law employer, it can escape the limitation by qualifying for the section 274(e)(3) exception. And if the PEO is not the employer, it also should escape, because the limit will be applied to the trucking company, as in *Beech*. The only way for a trucking company to escape the limit under the Eighth Circuit's approach is to argue that the PEO is the common-law employer and that the reimbursement arrangement or accounting does not qualify under the regulations.

■ *Transport Labor Contract/Leasing Inc.*, 98 AFTR 2d 2006-6143.

Prepared by R. Dan Fesler, CPA (inactive), CIA, CMA, *professor of accounting, and* Larry Maples, CPA (inactive), *Alumni Professor of Accounting, Tennessee Technological University, Cookeville, Tenn.* ❖

Technology Q&A

by Stanley Zarowin

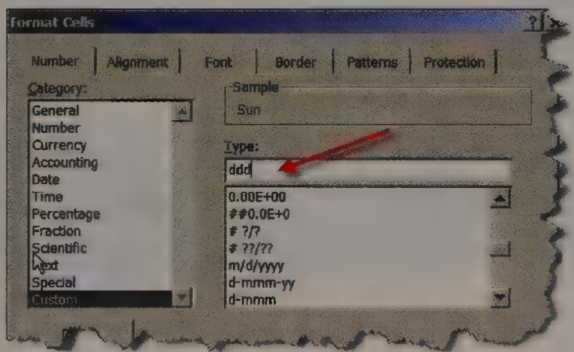
Excel translates a date into a day…Change Word's format defaults…Power to the traveler…
Make reading easier for those with dyslexia…Straighten a bent plug-in pin…
What I learned from two readers…Shortcuts

EXCEL TRANSLATES A DATE INTO A DAY

Q I have a delivery schedule in an Excel file, and on a regular basis I have to determine the day of the week of a future date. Does Excel have a way to speed the operation?

A I asked a colleague, and he surprised me with a simple solution.

Highlight the target cells, click on **Format**, **Cells** and the **Number** tab. Then click on **Custom**. In the box in the **Type** column, type dddd for the full name of the week and ddd for abbreviated names…



…and it does the job automatically.

3/1/07	Thu
3/4/07	Sun
3/20/07	Tue

» Key to Instructions

To help readers follow the instructions in this article, we use two different typefaces:

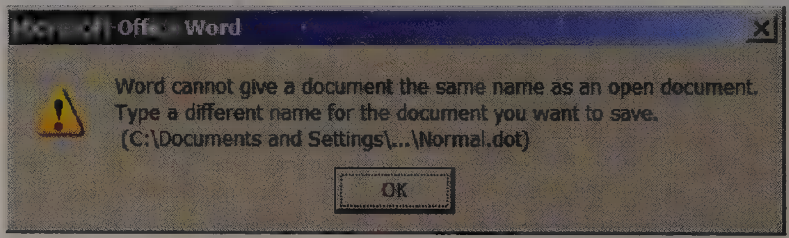
Boldface *type is used to identify the names of functions, menu items, agendas and URLs.*

Sans serif *type shows the names of files and the names of commands and instructions that users should type into the computer.*

CHANGE WORD'S FORMAT DEFAULTS

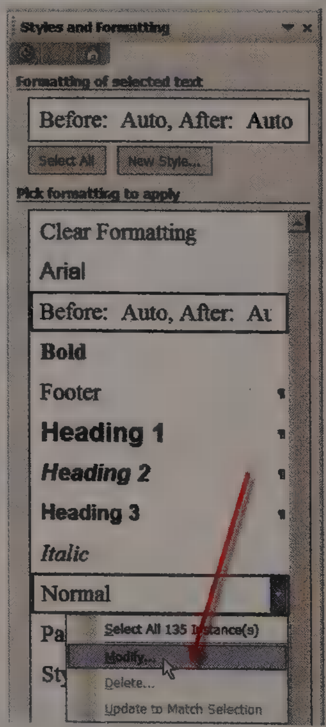
Q I'm trying to change my Word document defaults—such as the font and tab settings—and my computer keeps telling me I can't change my Normal.dot characteristics. I even went to Help (F1) and followed the instructions, but no luck there either. Help!

A I think I know what you're doing wrong. Let's back up a bit. Your goal is to change Word's Normal.dot; that's the template for all new Word documents created on your computer. If you try to create a document and name it Normal.dot, your computer will flash this screen:



There are two ways to change your Normal.dot. I think when you tried to open the existing Normal.dot, you probably did not open the *real* one. For example, if you do a search in Explorer, you'll probably find a few of them—each in a different location. The one you want is in C:\Documents and Settings\ *Your user name*\Application Data\ Microsoft\Templates\Normal.dot. When you change that file and save it, it will be your new default.

There's another way to change the default, which some users believe is easier: Open a new document and click on **Format**, **Styles and Formatting**, bringing up this screen:



If you right-click on **Normal**, a new screen appears with a **Modify** button. Click on it and use the **Modify Style** screen that appears to change the Normal.dot defaults. When done, click on **OK** and you have a new, custom Normal.dot default.

POWER TO THE TRAVELER

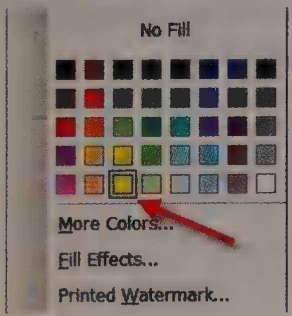
Q I travel a lot and one of my great frustrations is searching for a free electrical outlet in an airport to recharge my laptop and cell phone. Suggestions?

A There's a product for people like you. The XPower PowerSource Mobile 100, a pocket-size rechargeable lithium-ion battery, can recharge a laptop to run for two hours, a cell phone for 12 hours or a BlackBerry for 34 hours. It can be recharged 300 times before the battery needs replacement. It comes with two sockets for USB cords and has a standard AC outlet so you don't need any additional adapter plugs. The $129 device weighs about a pound. (*Details*: **www.xantrex.com.**)

MAKE READING EASIER FOR THOSE WITH DYSLEXIA

Q I have a mild case of dyslexia, which, among other things, makes reading a little difficult, especially reading the small, crowded type in spreadsheets. Do you have a recommendation?

A I have several. Most people with dyslexia or light-sensitive eyes find text on a white background—whether on a computer screen or paper—somewhat difficult to read. Adding a faint yellow tint to the page cuts down the reflected glare and makes focusing easier, whether or not you have eye problems.

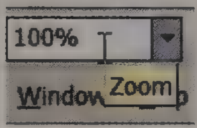


In Word, add the tint by clicking on **Format**, **Background** and then the color marked by the arrow (see screenshot).

In Excel, first highlight the entire worksheet by pressing Ctrl+A, then click on the **Fill Color** (paint bucket) icon and then the light yellow panel (see screenshot).

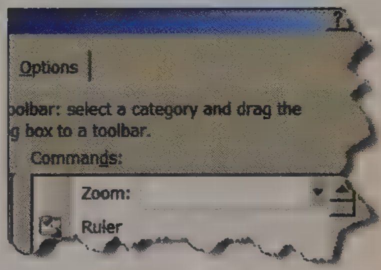
For help reading printed material, buy an 8½-by-11 yellow-tinted transparent plastic sheet at an office supply store and lay it over what you're reading to remove the glare.

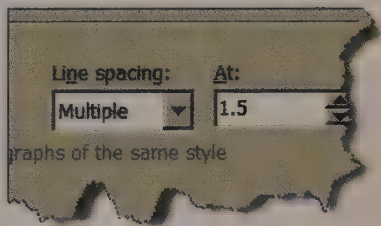
Another problem is the type size. While you can't do anything about printed material, you can adjust the computer's font size quite easily. Although I generally use 12-point type, for ease in reading I enlarge my personal view (without changing the document's format settings) by clicking on the **Zoom** icon (see screenshot).



If you don't have that icon on your toolbar, click on **Tools**, **Customize** and under the **Commands** heading, grab the **Zoom** icon (see screenshot) and drag it onto the toolbar. Do the same for Excel.

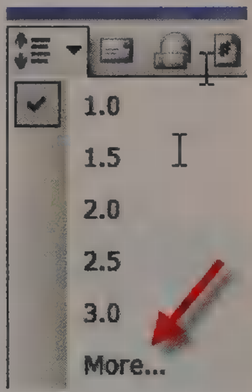
Enlarging the spacing between lines of type helps, too. I find two-line spacing too much and one-line spacing too little, but hidden among Word's little formatting adjustments is 1.5-line spacing, which I find just right. To access it, click on **Format**, then **Paragraph** and the **Indents and Spacing** tab. Under **Line spacing**, click on the down arrow to engage **Multiple**, and then dial the spacing to **1.5** (see screenshot).

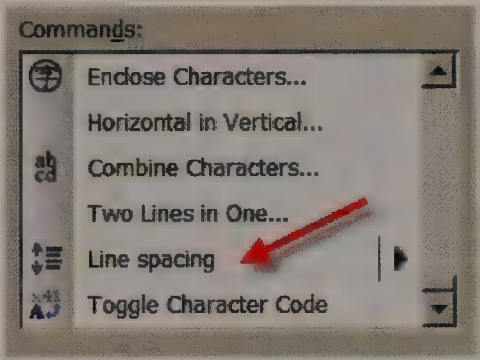




For convenience, you can place the **Line spacing** icon in your toolbar (see screenshot).

However, that icon is well-hidden: Look under the **Commands** tab and under **Format**; it's the next-to-last icon in the lengthy list.





STRAIGHTEN A BENT PLUG-IN PIN

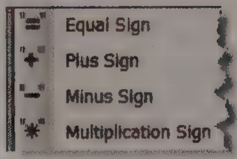
Q Although I'm not particularly handy, that doesn't stop me from tinkering inside my computer and setting up peripherals. However, when I have a cable or a component with plug-in pins and make one false move when I'm trying to insert it, a pin gets bent. How can I get it straight?

A First, I salute your independence and courage. Simply empty the lead from a 7-millimeter mechanical pencil and gently insert the bent pin in the hollow tip to straighten it. It works every time.

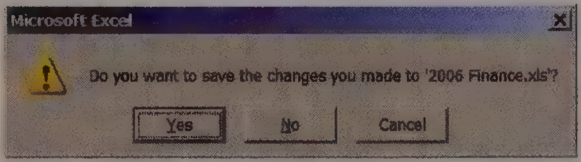
WHAT I LEARNED FROM TWO READERS

In the September column (page 80), I reported on an Excel shortcut for putting the equal (=) sign in a formula. Ron Freeman, CPA (inactive), accounting manager for CityForest Corp. of Ladysmith, Wis., suggested another way: Put the equal sign in the toolbar for easy access.

To do that, click on **Tools**, **Customize**, the **Commands** tab and then on **Insert**. Far down on the drop-down list are all the basic arithmetic functions (see screenshot). Drag the ones you want to the toolbar.



Someone else recently asked me why this screen sometimes pops up when he closes some, but not all, Excel files—even when he doesn't make a change in the spreadsheet:



Quite frankly, I didn't know. But reader Alan Hyde, a CPA at the Park West Gallery in Southfield, Mich., went searching on Microsoft's Knowledge site and discovered that when you close any worksheet with a volatile function—such as SUMIF, NOW, TODAY or OFFSET—the ominous screen will be triggered whether or not you changed anything. So rest assured that the screen's appearance is not a sign of trouble.

SHORTCUTS

- **Windows**: Alt+F4 to close and quit file.
- **Windows**: Alt+Space to display the main window's **System** menu. From the **System** menu you can restore, move, resize, minimize, maximize or close the window.
- **Windows**: Alt+Tab to switch between open programs.
- **Windows**: Ctrl+Esc to open **Start** menu.
- **Windows**: Shift+Delete to delete item permanently.
- **Word**: A quick way to open **Page Setup**: Double-click on the horizontal or vertical ruler.

Stanley Zarowin, a former JofA senior editor, is now a contributing editor to the magazine. His e-mail address is stanley.joatech@gmail.com.

Do you have technology questions for this column? Or, after reading an answer, do you have a better solution? Send them to contributing editor Stanley Zarowin via e-mail at stanley.joatech@gmail.com or by regular mail at the *Journal of Accountancy*, 220 Leigh Farm Road, Durham, NC 27707-8110.

Because of the volume of mail, we regret we cannot individually answer submitted questions. However, if a reader's question has broad interest, we will answer it in a forthcoming Technology Q&A column.

On occasion you may find you cannot implement a function I describe in this column. More often than not it's because not all functions work in every operating system or application. I try to test everything in the 2000 and XP editions of Windows and Office. It's virtually impossible to test them in all editions and it's equally difficult to find out which editions are incompatible with a function. I apologize for the inconvenience.

AICPA conferences

Balanced Scorecard

Workshop III: Executing Strategy With the Balanced Scorecard

AICPA Boardroom
New York, NY

April 9–10, 2007

CPE Credits: 16

Conference Highlights:

- Step-by-step approach to successfully understand, implement and execute the Balanced Scorecard
- How to translate strategy into operational terms
- Review organizational and individual alignment methods to get your ROI
- How to manage and execute strategy with data driven decisions
- Small, intimate sessions that allow for hands-on training and in-depth discussions

Tax Strategies for the High-Income Individual

Bellagio
Las Vegas, NV

April 30–May 1, 2007

CPE Credits: Up to 18 (main conference) and up to 8 (optional workshops)

Pre-Conference Optional Workshops:
Sunday, April 29

Conference Highlights:

- Income tax update
- Recent developments impacting real estate
- Hot Topics — Panel Discussion
- Families, money and CPAs
- Estate tax update
- Donor advised funds
- Tax strategies for closely-held business clients
- FLP update
- Federal tax legislative update

Business Valuation School

AICPA Boardroom
New York, NY

May 7–11, 2007

Also being held in:
Lewisville (Dallas), TX
August 20–24, 2007

CPE Credits: Up to 45

Conference Highlights:

- Get an introduction to valuation, an understanding of research and analysis and the asset approach
- Learn the income approach and cost of capital/rate of return
- Discuss the market approach, discounts and premiums
- Uncover types of reports, valuation standards and tax-related valuations
- Work through a full-day comprehensive case study

Banking School

University of Virginia
McIntire School of Commerce
Charlottesville, VA

May 13–18, 2007

CPE Credits: 40

Conference Highlights:

- Strategic problem solving with other professionals through NBS simulation
- Hands-on training based on actual case studies
- Expert instruction and practical applications — geared to CPAs
- Class discussion of hot topics including stock options, internal controls and late-breaking regulatory developments
- Guidance on accounting, auditing, taxation, lending, technology, government regulations and more

AICPA...Where to Turn

Below are commonly requested phone numbers and e-mail addresses for key areas, programs and initiatives at the Institute.

AICPA/CPA Logo Contacts	
AICPA Logo	919/402–4440
CPA Accessory Collection (Big Game Outfitters)	212/596–6299
CPA Logo	212/596–6114
Third-party logo requests	212/596–6107
AICPA Foundation	212/596–6225
AICPA Political Action Committee (AICPA PAC)	202/434–9276
Academic and Career Development	
Education Programs, Products	919/402–4006
Recruiting Materials for the Profession	919/402–4014
Accounting and Auditing Publications	201/938–3794
Accounting and Review Services	212/596–6250
Accounting Standards	212/596–6167
	www.pcfr.org
Advertising (*Journal of Accountancy*, *The Tax Adviser*)	
Classified Ads	800/237–9851
Display Ads	919/402–4886
Antifraud & Corporate Responsibility Resource Center	www.aicpa.org/antifraud
Audit & Accounting Technical Information Hotline	888/777–7077
Audit Committee Effectiveness Center	www.aicpa.org/audcommctr
Audit Quality Centers:	
Center for Audit Quality	202/609–8120
	www.thecaq.org
	www.aicpa.org/cpcaf
Employee Benefit Plan	202/434–9253
	www.aicpa.org/ebpaqc
Governmental	202/434–9259
	www.aicpa.org/gaqc
Auditing Standards	212/596–6032
Benevolent Fund	866/527–2228
	919/490–4315
Committee Appointments	212/596–6097
	volunteers@aicpa.org and http://volunteers.aicpa.org
Committee Reimbursements	asingletary@aicpa.org
Competency Self-Assessment Tool	www.cpa2biz.com/CAT
Copyright Permissions	www.copyright.com/firsttimeusers.asp
CPA Client Bulletin, *CPA Client Tax Letter*	888/777–7077
CPA Letter, The (editorial)	212/596–6112
Credentials and Technical Member Sections	201/938–3828
Accredited in Business Valuation credential	abv@aicpa.org
Business Valuation/Forensic & Litigation Services	BV-FLS@aicpa.org
Certified Information Technology Professional credential	citp@aicpa.org
Information Technology Services	infotech@aicpa.org
Personal Financial Planning Services	pfp@aicpa.org
Personal Financial Specialist credential	pfs@aicpa.org
Examinations (Uniform CPA Exam)	www.cpa-exam.org
Federal Legislation (non-tax congressional matters)	202/434–9205
Federal Regulatory Matters (non-tax-related)	202/434–9253
Financial Literacy Campaign	www.aicpa.org/financialliteracy/index.asp
	financialliteracy@aicpa.org
General Counsel	212/596–6245
	rmiller@aicpa.org
Government Member Inquiries	212/596–6085
Industry Member Programs, New Finance	919/402–4816
International Technical Relations	212/596–6048
Joint Trial Board (disciplinary actions)	212/596–6101
	ckane@aicpa.org and www.aicpa.org/pubs/cpaltr/discipli.htm
Journal of Accountancy (editorial)	919/402–4449
Library (University of Mississippi)	866/806–2133
	aicpalib@olemiss.edu
	www.olemiss.edu/depts/general_library/aicpa
Media Relations	212/596–6106
Member Communications	212/596–6117
Member Service Center (9:00 a.m.–6:00 p.m., ET)	888/777–7077
(to update mail, e-mail addresses, membership information,* and pay dues, register for conferences, obtain Web support including CPA2Biz.com, inquire about purchases or subscriptions, and general membership/service inquiries)	service@aicpa.org
Fax number	800/362–5066
Minority Initiatives	919/402–4006
PCPS—member section for local, regional firms	800/CPA–FIRM
(Small firm issues)	212/596–6039
Peer Review	888/817–3277
Political Action Committee	202/434–9276
Practicing CPA, The (editorial)	201/938–3502
Professional Ethics, Ethics Hotline	888/777–7077
Behavioral or Independence Issues	201/938–3179
Technical Standard Issues	919/402–4921
Professional Publications	201/938–3794
Specialized Publications	201/938–3795
State Legislation	202/434–9201
Tax Adviser, The (editorial)	201/938–3445
Tax Services Member Section	202/434–9270
Work/Life and Women's Initiatives	919/402–4006

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Insurance Programs	
Automobile	877/999–3626
Catastrophe Major Medical	888/294–0028
Commercial Property & Liability	866/283–7127
Disability	800/223–7473
Group Life for Firms	800/223–7473
Group Variable Universal Life	800/223–7473
Home	866/366–4607
Life (Member/Spouse)	800/223–7473
Long-Term Care	800/223–7473
Medicare Supplement Plan	800/957–3195
Personal Liability Umbrella	800/223–7473
Professional Liability, CPA EmployerGard	800/221–3023
Retirement Programs	
Nationwide Financial	888/401K–CPA
T. Rowe Price (IRAs)	800/38–AICPA
Audio Conferencing (Netspoke Genesys)	800/399–3942
BlackBerry (RIM)	www.blackberryforthecpa.com
Business Formation Services (BizFilings.com)	800/981–7183
Car Rental (Hertz, CDP #12353)	800/654–2200
Checks and Business Forms	
(AICPA Checks and Forms from Harland)	800/873–9313
Computers (Dell Corporation)	800/945–8364
(Lenovo)	800/426–7235, ext. 3373
Credit Card (Chase)	800/824–4313
Credit Card Processing (Chase)	800/824–4313
Custody and Clearing Services (Fidelity)	800/854–4772, option 400
Home Mortgages and Equity Loans (Wells Fargo)	800/272–1210
Hotels (Starwood Hotels & Resorts Worldwide)	888/625–4988
Overnight Delivery (DHL)	800/MEMBERS
Prism e-Solutions	888/386–2330
	www.prismesolutions.com
Professional Placement (Robert Half)	888/744–4089
Tax Research Material (RIA Group)	800/950–1216
Xerox Corporation (#0706109)	800/275–9376, ext. 272

* You can change your address and employment information online through www.aicpa.org/about/dues.htm, or e-mail, mail or fax the information to the Member Service Center. In either case, *The CPA Letter* and *Journal of Accountancy* will automatically be notified. You can also update your e-mail address account information online at www.cpa2biz.com.

NEW JERSEY (EWING)	NEW JERSEY (JERSEY CITY)	NEW YORK	NORTH CAROLINA	WASHINGTON, D.C.	AICPA/PDI TEXAS
Parkway Corporate Center 1230 Parkway Avenue Ewing, NJ 08628 (609/671–2930)	Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 (201/938–3000)	1211 Avenue of the Americas New York, NY 10036-8775 (212/596–6200)	220 Leigh Farm Road Durham, NC 27707-8110 (919/402–4500)	1455 Pennsylvania Avenue, NW Washington, D.C. 20004-1081 (202/737–6600)	1720 Lakepointe Drive Suite 117 Lewisville, TX 75057-6425 (888/247–3277)

EXPOSURE DRAFTS OUTSTANDING

(This list was compiled as of Feb. 1, 2007. For exposure drafts issued after that date, consult *The CPA Letter*.
Note: The policy for updating the list of exposure drafts is that a document should remain on the list until a final document has been issued or the project has been dropped. However, no comments will be received after the comments deadline has expired. The list is not all-inclusive but is intended to present the exposure drafts of particular interest to professional accountants.)

Issue Date	Title or Description	Comment Deadline
FASB		
12/8/06	Disclosures About Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133	3/2/07
10/9/06	Not-for-Profit Organizations: Goodwill and Other Intangible Assets Acquired in a Merger or Acquisition (an amendment of FASB Statement No. 142)	1/29/07
10/9/06	Not-for-Profit Organizations: Mergers and Acquisitions	1/29/07
1/25/06	The Fair Value Option for Financial Assets and Financial Liabilities (including an amendment of FASB Statement No. 115)	4/10/06
9/30/05	Earnings per Share—an amendment of FASB Statement No. 128 (revision of Exposure Draft issued 12/15/03)	11/30/05
8/11/05	Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140	10/10/05
6/30/05	Business Combinations—a replacement of FASB Statement No. 141	10/28/05
6/30/05	Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries—a replacement of ARB No. 51	10/28/05
4/28/05	The Hierarchy of Generally Accepted Accounting Principles	6/27/05
AcSEC (AICPA)		
6/19/03	Proposed Statement of Position, Allowance for Credit Losses	9/19/03
12/17/02	Proposed Statement of Position, Clarification of the Scope of the Audit and Accounting Guide Audits of Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investment in Investment Companies	3/31/03
ASB (AICPA)		
7/28/06	Proposed Statement on Quality Control Standards: A Firm's System of Quality Control	9/30/06
1/19/06	Proposed Statement on Standards for Attestation Engagements: Reporting on an Entity's Internal Control Over Financial Reporting	5/19/06
5/9/05	Proposed Statement on Auditing Standards: Amendment to Statement on Auditing Standards No. 69, *The Meaning of* Present Fairly in Conformity with Generally Accepted Accounting Principles, for Nongovernmental Entities	6/27/05
ARSC (AICPA)		
12/1/06	Elimination of Certain References to Statements on Auditing Standards and Incorporation of Appropriate Guidance Into Statements on Standards for Accounting and Review Services	5/18/07
OTHER (AICPA)		
12/13/06	Proposed Revisions to AICPA/NASBA Uniform Accountancy Act Section 23	5/15/07
10/16/06	Proposed Statement on Standards for Valuation Services, Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset	12/15/06
9/8/06	Omnibus Proposal of Professional Ethics Division Interpretations and Rulings	11/8/06
12/30/05	Proposed Statement on Standards for Tax Services No. 9, "Quality Control"	8/31/06
3/7/01	Statement on Standards for Continuing Professional Education Programs	8/1/01
SEC		
6/26/02	Framework for Enhancing the Quality of Financial Information Through Improvement of Oversight of the Auditing Process; Release Nos. 33-8109; 34-46120; 35-27543; IA-2039; IC-25624	9/3/02
5/10/02	Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies (Release Nos. 33-8098; 34-45907)	7/19/02
4/12/02	Form 8-K Disclosure of Certain Management Transactions; Release No. 33-8090	6/24/02
4/12/02	Form 8-K Disclosure of Certain Management Transactions; Release No. 34-45742	6/24/02
2/18/00	SEC Concept Release: International Accounting Standards	5/23/00
1/21/00	Supplementary Financial Information	4/17/00
GASB		
12/29/06	Accounting and Financial Reporting for Intangible Assets	3/23/07
12/15/06	Pension Disclosures—an Amendment of GASB Statements No. 25 and No. 27	2/28/07
10/20/06	Fund Balance Reporting and Governmental Fund Type Definitions (Invitation to comment)	1/31/07
8/14/06	Elements of Financial Statements	11/17/06
4/28/06	Accounting and Financial Reporting for Derivatives (Preliminary Views Document)	7/28/06
IFAC		
1/4/07	Practical Experience Requirements—Initial Professional Development for Professional Accountants	3/31/07
12/29/06	Proposed Revised Section 290 of the Code of Ethics for Professional Accountants, Independence—Audit and Review Engagements, and Proposed Section 291, Independence—Other Assurance Engagements	4/30/07

New additions appear in bold type.

EXPOSURE DRAFTS OUTSTANDING

Issue Date	Title or Description	Comment Deadline
12/22/06	Proposed Revised and Redrafted International Standard on Auditing ISA 580 (Revised and Redrafted), Written Representations	4/30/07
12/22/06	Proposed Revised and Redrafted International Standard on Auditing ISA 540 (Revised and Redrafted), Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures Proposed Withdrawal of ISA 545, Auditing Fair Value Measurements and Disclosures	4/30/07
12/22/06	Proposed Redrafted International Standard on Auditing ISA 230 (Redrafted), Audit Documentation	3/31/07
12/22/06	Proposed Redrafted International Standard on Auditing ISA 560 (Redrafted), Subsequent Events	3/31/07
12/22/06	Proposed Redrafted International Standard on Auditing ISA 610 (Redrafted), The Auditor's Consideration of the Internal Audit Function	3/31/07
12/22/06	Proposed Redrafted International Standard on Auditing ISA 720 (Redrafted), The Auditor's Responsibility in Relation to Other Information in Documents Containing Audited Financial Statements	3/31/07
12/1/06	Strategic and Operational Plan, 2007-2009	2/28/07
11/22/06	Proposed Amendment to International Public Sector Accounting Standard, "Financial Reporting Under the Cash Basis of Accounting," "Financial Reporting Under the Cash Basis of Accounting-Disclosure Requirements for Recipients of External Assistance"	3/31/07
11/15/06	Proposed Drafted International Standards on Auditing ISA 320 (Revised and Redrafted), Materiality in Planning and Performing an Audit ISA 450 (Redrafted), Evaluation of Misstatements Identified During the Audit	2/15/07
11/15/06	Proposed Redrafted International Standard on Auditing Proposed ISA 260 (Revised and Redrafted), Communication With Those Charged With Governance	2/15/07
11/8/06	Defining and Developing an Effective Code of Conduct	2/16/07
10/26/06	Proposed International Public Sector Accounting Standard, "Employee Benefits"	2/28/07
10/18/06	Proposed International Public Sector Accounting Standard, "Impairment of Cash-Generating Assets"	2/28/07
3/24/06	Proposed International Standard on Auditing 600 (Revised and Redrafted), "The Audit of Group Financial Statements"	7/31/06
2/28/06	Accounting for Heritage Assets Under the Accrual Basis of Accounting	6/30/06
9/23/05	Improvements to International Public Sector Accounting Standards	1/31/06
9/23/05	Equal Authority of Paragraphs in IPSASs	1/31/06
2/4/05	Proposed International Public Sector Accounting Standard, "Financial Reporting Under the Cash Basis of Accounting—Disclosure Requirements for Recipients of External Assistance"	6/15/05
1/20/04	Accounting for Social Policies of Governments	6/30/04
FASAB		
10/23/06	Accounting for Social Insurance, Revised (Preliminary Views)	4/16/07
8/1/06	Proposed Interpretation: Items Held for Remanufacture	10/16/06
6/7/06	Proposed Statement of Federal Financial Accounting Concepts: Definition and Recognition of Elements of Accrual-Basis Financial Statements	8/5/06
GAO		
6/9/06	Government Auditing Standards, 2006 Revision	8/15/06
PCAOB		
12/19/06	Proposed Auditing Standard—An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements	2/26/07

At the present time, most PCAOB exposure drafts have very short comment periods. A list of outstanding PCAOB exposure drafts is available online at www.pcaobus.org.

INFORMATION

The initials stand for the following organizations. Exposure drafts are available online at the Web addresses below or copies may be obtained at the address in parentheses (unless otherwise indicated).

FASB— Financial Accounting Standards Board (Order Department, Financial Accounting Standards Board, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116); also available online at www.fasb.org

GASB— Governmental Accounting Standards Board (Order Department, Governmental Accounting Standards Board, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116); also available online at www.gasb.org

AICPA— American Institute of CPAs (American Institute of Certified Public Accountants, 220 Leigh Farm Road, Durham, NC 27707-8110. AICPA publishes exposure drafts exclusively on the Web at www.aicpa.org. Print copies are not available.

IASB— International Accounting Standards Board (International Accounting Standards Board, 30 Cannon Street, London EC4M 6XH, United Kingdom), also available online at www.iasb.org

IFAC— International Federation of Accountants (International Federation of Accountants, 545 Fifth Avenue, 14th Floor, New York, NY 10017); also available online at www.ifac.org

SEC— Securities and Exchange Commission (Securities and Exchange Commission, 450 5th Street, N.W., Washington, DC 20549); also available online at www.sec.gov

FASAB— Federal Accounting Standards Advisory Board (Federal Accounting Standards Advisory Board, 441 G Street, N.W., Suite 6814, Washington, DC 20548); also available online at www.fasab.gov

GAO— U.S. Government Accountability Office (Government Auditing Standards Comments, Marcia B. Buchanan, U.S. General Accounting Office, Room 5089, 441 G Street, N.W., Washington, DC 20548); www.gao.gov

PCAOB— Public Company Accounting Oversight Board, 1666 K Street, N.W., Washington, DC 20006-2803; www.pcaobus.org

AICPA TECHNICAL HOTLINE

The Technical Information Service answers inquiries about specific audit or accounting problems. Call toll-free 888-777-7077 or e-mail query to aahotline@aicpa.org. This service is free to AICPA members.

OFFICIAL RELEASES

SAS NO. 114...SSARS INTERPRETATION

SAS NO. 114

The Auditor's Communication With Those Charged With Governance

(Supersedes Statement on Auditing Standards No. 61, Communication With Audit Committees, *as amended, AICPA,* Professional Standards.*)*

1. This Statement on Auditing Standards (SAS) establishes standards and provides guidance on the auditor's communication with those charged with governance in relation to an audit of financial statements.[1] Although this Statement applies regardless of an entity's governance structure or size, particular considerations apply where all of those charged with governance are involved in managing an entity. This Statement does not establish requirements regarding the auditor's communication with an entity's management or owners unless they are also charged with a governance role.

2. This Statement has been drafted in terms of an audit of financial statements, but may also be applied, adapted as necessary in the circumstances, to audits of other historical financial information when those charged with governance have a responsibility to oversee the preparation and presentation of the other historical financial information.

3. For purposes of this Statement:

a. Those charged with governance means the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. In some cases, those charged with governance are responsible for approving the entity's financial statements (in other cases management has this responsibility). For entities with a board of directors, this term encompasses the term *board of directors* or *audit committee* used elsewhere in generally accepted auditing standards.

b. Management means the person(s) responsible for achieving the objectives of the entity and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management is responsible for the financial statements, including designing, implementing, and maintaining effective internal control over financial reporting.

4. Recognizing the importance of effective two-way communication to the audit, this Statement provides a framework for the auditor's communication with those charged with governance and identifies some specific matters to be communicated with them. Additional matters to be communicated are identified in other SASs (see Appendix A). Further matters may be communicated by agreement with those charged with governance or management, or in accordance with external requirements.

5. The auditor must communicate with those charged with governance matters related to the financial statement audit that are, in the auditor's professional judgment, significant and relevant to the responsibilities of those charged with governance in overseeing the financial reporting process.

6. Clear communication of specific matters in accordance with this Statement is an integral part of every audit. However, the auditor is not required to perform procedures specifically to identify other significant matters to communicate with those charged with governance.

THE ROLE OF COMMUNICATION

7. The principal purposes of communication with those charged with governance are to:

a. Communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, and an overview of the scope and timing of the audit.

b. Obtain from those charged with governance information relevant to the audit.

c. Provide those charged with governance with timely observations arising from the audit that are relevant to their responsibilities in overseeing the financial reporting process.

8. This Statement focuses primarily on communications from the auditor to those charged with governance. However, effective two-way communication is also very important in assisting:

a. The auditor and those charged with governance in understanding matters related to the audit in context, and in developing a constructive working relationship. This relationship is developed while maintaining the auditor's independence and objectivity.

b. The auditor in obtaining from those charged with governance information relevant to the audit. For example, those charged with governance may assist the auditor in understanding the entity and its environment, in identifying appropriate sources of audit evidence, and in providing information about specific transactions or events.

c. Those charged with governance in fulfilling their responsibility to oversee the financial reporting process, thereby reducing the risks of material misstatement of the financial statements.

9. Although the auditor is responsible for communicating specific matters in accordance with this Statement, management also has a responsibility to communicate matters of governance interest to those charged with governance. Communication by the auditor does not relieve management of this responsibility.

LEGAL CONSIDERATIONS

10. In certain circumstances, the auditor may be required to report to a regulatory or enforcement body certain matters communicated with those charged with governance. For example, governmental auditing standards require auditors to report fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse directly to parties outside the audited entity in certain circumstances.

11. In rare circumstances, laws or regulations may prevent the auditor from communicating certain matters with those charged with governance, or others within the entity. For example, laws or regulations may specifically prohibit a communication, or other action, that might prejudice an investigation by an appropriate authority into an actual or suspected illegal act. In such circumstances, it may be appropriate for the auditor to seek legal advice.

THOSE CHARGED WITH GOVERNANCE

12. The auditor should determine the appropriate person(s) within the entity's governance structure with whom to communicate. The appropriate person(s) may vary depending on the matter to be communicated.

13. Governance structures vary by entity, reflecting influences such as size and ownership characteristics. For example:

• In some entities, those charged with governance hold positions that are an integral part of the entity's legal structure, for example, company directors. For other entities, a body that is not part of the entity may be charged with governance, as with some government agencies.

1. The provisions of this Statement apply to audits of financial statements prepared either in accordance with generally accepted accounting principles or in accordance with a comprehensive basis of accounting other than generally accepted accounting principles. References in this Statement to generally accepted accounting principles are intended to also refer to other comprehensive bases of accounting when the reference is relevant to the basis of accounting used.

• In some cases, some or all of those charged with governance also have management responsibilities. In others, those charged with governance and management are different people.

14. In most entities, governance is the collective responsibility of a governing body, such as a board of directors, a supervisory board, partners, proprietors, a committee of management, trustees, or equivalent persons. In some smaller entities, however, one person may be charged with governance, such as the owner-manager where there are no other owners, or a sole trustee. When governance is a collective responsibility, a subgroup, such as an audit committee or even an individual, may be charged with specific tasks to assist the governing body in meeting its responsibilities.

15. Such diversity means that it is not possible for this Statement to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Also, in some cases the appropriate person(s) with whom to communicate may not be clearly identifiable from the engagement circumstances, for example, entities where the governance structure is not formally defined, such as some family-owned entities, some not-for-profit organizations, and some government entities. The auditor's understanding of the entity's governance structure and processes obtained in accordance with SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, is relevant in deciding with whom to communicate matters.

16. When the appropriate person(s) with whom to communicate are not clearly identifiable, the auditor and the engaging party should agree on the relevant person(s) within the entity's governance structure with whom the auditor will communicate. When the entity being audited is a component[2] of a group,[3] the appropriate person(s) with whom to communicate is dependent on the nature of the matter to be communicated and the terms of the engagement.

Communication With the Audit Committee or Other Subgroup of Those Charged With Governance

17. Audit committees (or similar subgroups with different names) exist in many entities. Although their specific authority and functions may differ, communication with the audit committee, where one exists, is a key element in the auditor's communication with those charged with governance. Good governance principles suggest that:

- The auditor has access to the audit committee as necessary.
- The chair of the audit committee and, when relevant, the other members of the audit committee, meet with the auditor periodically.
- The audit committee meets with the auditor without management present at least annually.

18. The auditor should evaluate whether communication with a subgroup of those charged with governance, such as the audit committee or an individual, adequately fulfills the auditor's responsibility to communicate with those charged with governance. When considering communicating with a subgroup of those charged with governance, the auditor may take into account such matters as:

- The respective responsibilities of the subgroup and the governing body.
- The nature of the matter to be communicated.
- Relevant legal or regulatory requirements.
- Whether the subgroup (*a*) has the authority to take action in relation to the information communicated and (*b*) can provide further information and explanations the auditor may need.
- Whether the auditor is aware of potential conflicts of interest between the subgroup and other members of the governing body.
- Whether there is also a need to communicate the information, in full or in summary form, to the governing body. This decision may be influenced by the auditor's assessment of how effectively and appropriately the subgroup communicates relevant information with the governing body. The auditor retains the right to communicate with the governing body, a fact the auditor may make explicit in the terms of the engagement.

COMMUNICATION WITH MANAGEMENT

19. Many matters may be discussed with management in the ordinary course of an audit, including matters to be communicated with those charged with governance in accordance with this Statement. Such discussions recognize management's executive responsibility for the conduct of the entity's operations and, in particular, management's responsibility for the financial statements.

20. Before communicating matters with those charged with governance, the auditor may discuss them with management unless that is inappropriate. For example, it may not be appropriate to discuss with management questions of management's competence or integrity. In addition to recognizing management's responsibility, these initial discussions may clarify facts and issues, and give management an opportunity to provide further information and explanations. Similarly, when the entity has an internal audit function, the auditor may discuss matters with the internal auditor before communicating with those charged with governance.

When All of Those Charged With Governance Are Involved in Managing the Entity

21. In some cases, all of those charged with governance are involved in managing the entity. In these cases, if matters required by this Statement are communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matters need not be communicated again with those same person(s) in their governance role.

22. When all of those charged with governance are involved in managing the entity, the auditor should consider whether communication with person(s) with financial reporting responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity. (See paragraphs 12 and 18.)

MATTERS TO BE COMMUNICATED

23. The auditor should communicate with those charged with governance:

a. The auditor's responsibilities under generally accepted auditing standards (see paragraphs 26 through 28);

b. An overview of the planned scope and timing of the audit (see paragraphs 29 through 33); and

c. Significant findings from the audit (see paragraphs 34 through 44).

24. Management's communication of these matters to those charged with governance does not relieve the auditor of the responsibility to also communicate them. However, communication of these matters by management may affect the form or timing of the auditor's communication.

25. Nothing in this Statement precludes the auditor from communicating any other matters to those charged with governance.

The Auditor's Responsibilities Under Generally Accepted Auditing Standards

26. The auditor should communicate with those charged with governance the auditor's responsibilities under generally accepted auditing standards, including that:

a. The auditor is responsible for forming and expressing an opinion about whether the financial statements that have been prepared by management with the oversight of those charged with governance are presented fairly, in all material respects, in conformity with generally accepted accounting principles.

b. The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

These responsibilities may be communicated through the engagement letter, or other form of contract that records the terms of the engagement, if that letter or contract is provided to those charged with governance.

27. The auditor may also communicate that:

a. The auditor is responsible for performing the audit in accordance with generally accepted auditing standards and that the audit is designed to obtain reasonable, rather than absolute, assurance about whether the financial statements are free of material misstatement.

b. An audit of financial statements includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control over financial reporting.

c. The auditor is responsible for communicating significant matters related to the financial state-

2. *Component* means a head office, parent, division, branch, subsidiary, joint venture, associated company, equity investee, or other entity whose financial information is or should be included in the consolidated financial statements of a group.

3. *Group* means an entity whose consolidated financial statements include or should include financial information of more than one component.

ment audit that are, in the auditor's professional judgment, relevant to the responsibilities of those charged with governance in overseeing the financial reporting process. Generally accepted auditing standards do not require the auditor to design procedures for the purpose of identifying other matters to communicate with those charged with governance.

d. When applicable, the auditor is also responsible for communicating particular matters required by laws or regulations, by agreement with the entity or by additional requirements applicable to the engagement.

28. SAS No. 8, *Other Information in Documents Containing Audited Financial Statements*, establishes the auditor's responsibility for information prepared by management that accompanies the audited financial statements.[4] If the entity includes other information in documents containing audited financial statements, the auditor should communicate with those charged with governance the auditor's responsibility with respect to such other information, any procedures performed relating to the other information, and the results.

Planned Scope and Timing of the Audit

29. The auditor should communicate with those charged with governance an overview of the planned scope and timing of the audit. However, it is important for the auditor not to compromise the effectiveness of the audit, particularly where some or all of those charged with governance are involved in managing the entity. For example, communicating the nature and timing of detailed audit procedures may reduce the effectiveness of those procedures by making them too predictable. Certain factors described in paragraph 53 may be relevant in determining the nature and extent of this communication.

30. Communication regarding the planned scope and timing of the audit may:

a. Assist those charged with governance in understanding better the consequences of the auditor's work for their oversight activities, discussing with the auditor issues of risk and materiality, and identifying any areas in which they may request the auditor to undertake additional procedures; and

b. Assist the auditor to understand better the entity and its environment.

31. Matters communicated may include the following:

- How the auditor proposes to address the significant risks of material misstatement, whether due to fraud or error.
- The auditor's approach to internal control relevant to the audit, including, when applicable, whether the auditor will express an opinion on the effectiveness of internal control over financial reporting.
- The concept of materiality in planning and executing the audit, focusing on the factors considered rather than on specific thresholds or amounts.
- Where the entity has an internal audit function, the extent to which the auditor will use the work of internal audit, and how the external and internal auditors can best work together.

32. Other planning matters that the auditor may consider discussing with those charged with governance include:

- The views of those charged with governance about:
  - The appropriate person(s) in the entity's governance structure with whom to communicate.
  - The allocation of responsibilities between those charged with governance and management.
  - The entity's objectives and strategies, and the related business risks that may result in material misstatements.
  - Matters those charged with governance consider warrant particular attention during the audit, and any areas where they request additional procedures to be undertaken.
  - Significant communications with regulators.
  - Other matters those charged with governance believe are relevant to the audit of the financial statements.
- The attitudes, awareness, and actions of those charged with governance concerning (a) the entity's internal control and its importance in the entity, including how those charged with governance oversee the effectiveness of internal control and (b) the detection or the possibility of fraud.
- The actions of those charged with governance in response to developments in financial reporting, laws, accounting standards, corporate governance practices, and other related matters.
- The actions of those charged with governance in response to previous communications with the auditor.

33. While communication with those charged with governance may assist the auditor in planning the scope and timing of the audit, it does not change the auditor's sole responsibility to determine the overall audit strategy and the audit plan, including the nature, timing, and extent of procedures necessary to obtain sufficient appropriate audit evidence.

Significant Findings From the Audit

34. The auditor should communicate with those charged with governance the following matters:

a. The auditor's views about qualitative aspects of the entity's significant accounting practices, including accounting policies, accounting estimates, and financial statement disclosures (see paragraphs 37 and 38).

b. Significant difficulties, if any, encountered during the audit (see paragraph 39).

c. Uncorrected misstatements, other than those the auditor believes are trivial, if any (see paragraphs 40 and 41).

d. Disagreements with management, if any, (see paragraph 42).

e. Other findings or issues, if any, arising from the audit that are, in the auditor's professional judgment, significant and relevant to those charged with governance regarding their oversight of the financial reporting process.

35. Unless all of those charged with governance are involved in managing the entity, the auditor also should communicate:

a. Material, corrected misstatements that were brought to the attention of management as a result of audit procedures. The auditor also may communicate other corrected immaterial misstatements, such as frequently recurring immaterial misstatements that may indicate a particular bias in the preparation of the financial statements.

b. Representations the auditor is requesting from management. The auditor may provide those charged with governance with a copy of management's written representations.

c. Management's consultations with other accountants (see paragraph 43).

d. Significant issues, if any, arising from the audit that were discussed, or the subject of correspondence, with management (see paragraph 44).

36. The communication of significant findings from the audit may include requesting further information from those charged with governance in order to complete the audit evidence obtained. For example, the auditor may confirm that those charged with governance have the same understanding of the facts and circumstances relevant to specific transactions or events.

Qualitative Aspects of the Entity's Significant Accounting Practices

37. Generally accepted accounting principles provide for the entity to make accounting estimates and judgments about accounting policies and financial statement disclosures. Open and constructive communication about qualitative aspects of the entity's significant accounting practices may include comment on the acceptability of significant accounting practices. Appendix B provides guidance on the matters that may be included in this communication.

38. The auditor should explain to those charged with governance why the auditor considers a significant accounting practice not to be appropriate and, when considered necessary, request changes. If requested changes are not made, the auditor should inform those charged with governance that the auditor will consider the effect of this on the financial statements of the current and future years, and on the auditor's report.

Significant Difficulties Encountered During the Audit

39. The auditor should inform those charged with governance of any significant difficulties encountered in dealing with management related to the performance of the audit. Significant difficulties encountered during the audit may include such matters as:

- Significant delays in management providing required information.

4. Guidance on the auditor's consideration of other information is also provided by "Required Supplementary Information," of Statement on Auditing Standards (SAS) No. 52, *Omnibus Statement on Auditing Standards—1987*, and SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*.

- An unnecessarily brief time within which to complete the audit.
- Extensive unexpected effort required to obtain sufficient appropriate audit evidence.
- The unavailability of expected information.
- Restrictions imposed on the auditors by management.
- Management's unwillingness to provide information about management's plans for dealing with the adverse effects of the conditions or events that lead the auditor to believe there is substantial doubt about the entity's ability to continue as a going concern.

In some circumstances, such difficulties may constitute a scope limitation that leads to a modification of the auditor's opinion.

Uncorrected Misstatements

40. SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*, requires the auditor to accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are trivial, and communicate them to the appropriate level of management. The auditor should communicate with those charged with governance uncorrected misstatements and the effect that they may have on the opinion in the auditor's report, and request their correction. In communicating the effect that material uncorrected misstatements may have on the opinion in the auditor's report, the auditor should communicate them individually. Where there are a large number of small uncorrected misstatements, the auditor may communicate the number and overall monetary effect of the misstatements, rather than the details of each individual misstatement.

41. The auditor should discuss with those charged with governance the implications of a failure to correct known and likely misstatements, if any, considering qualitative as well as quantitative considerations, including possible implications in relation to future financial statements. The auditor should also communicate with those charged with governance the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

Disagreements With Management

42. The auditor should discuss with those charged with governance any disagreements with management, whether or not satisfactorily resolved, about matters that individually or in the aggregate could be significant to the entity's financial statements or the auditor's report. Disagreements with management may occasionally arise over, among other things, the application of accounting principles to the entity's specific transactions and events and the basis for management's judgments about accounting estimates. Disagreements may also arise regarding the scope of the audit, disclosures to be included in the entity's financial statements, and the wording of the auditor's report. For purposes of this Statement, disagreements do not include differences of opinion based on incomplete facts or preliminary information that are later resolved.

Management's Consultations With Other Accountants

43. In some cases, management may decide to consult with other accountants about auditing and accounting matters. When the auditor is aware that such consultation has occurred, the auditor should discuss with those charged with governance his or her views about significant matters that were the subject of such consultation.[5]

Significant Issues Discussed, or Subject to Correspondence, With Management

44. The auditor should communicate with those charged with governance any significant issues that were discussed or were the subject of correspondence with management. Significant issues may include such matters as:
- Business conditions affecting the entity, and business plans and strategies that may affect the risks of material misstatement.
- Discussions or correspondence in connection with the initial or recurring retention of the auditor including, among other matters, any discussions or correspondence regarding the application of accounting principles and auditing standards.

Independence

45. Generally accepted auditing standards require independence for all audits. Relevant matters to consider in reaching a conclusion about independence include circumstances or relationships that create threats to auditor independence and the related safeguards that have been applied to eliminate those threats or reduce them to an acceptable level.[6]

46. Although the auditor's report affirms the auditor's independence, in certain situations, particularly for public interest entities,[7] the auditor may determine that it is appropriate to communicate with those charged with governance circumstances or relationships (for example, financial interests, business or family relationships, or nonaudit services provided or expected to be provided) that in the auditor's professional judgment may reasonably be thought to bear on independence and that the auditor gave significant consideration to in reaching the conclusion that independence has not been impaired.

47. The form and timing of communications regarding independence may be affected by the entity's governance structure and whether a formal subgroup such as an audit committee exists. In situations where all of those charged with governance are involved in managing the entity, the auditor may determine that those charged with governance have been informed of relevant facts regarding the auditor's independence through their management activities or through other means, such as the engagement letter. This is particularly likely where the entity is owner-managed, and the auditor's firm has little involvement with the entity beyond a financial statement audit.

THE COMMUNICATION PROCESS

Establishing a Mutual Understanding

48. The auditor should communicate with those charged with governance the form, timing, and expected general content of communications. Clear communication of the auditor's responsibilities (paragraphs 26 through 28), an overview of the planned scope and timing of the audit (paragraphs 29 through 33), and the expected general content of communications helps establish the basis for effective two-way communication.

49. Matters that may also contribute to effective two-way communication include discussion of:
- The purpose of communications. When the purpose is clear, the auditor and those charged with governance are in a better position to have a mutual understanding of relevant issues and the expected actions arising from the communication process.
- The form in which communications will be made.
- The person(s) on the audit team and among those charged with governance who will communicate regarding particular matters.
- The auditor's expectation that communication will be two way, and that those charged with governance will communicate with the auditor matters they consider relevant to the audit. Such matters might include strategic decisions that may significantly affect the nature, timing, and extent of audit procedures; the suspicion or the detection of fraud; or concerns about the integrity or competence of senior management.
- The process for taking action and reporting back on matters communicated by the auditor.
- The process for taking action and reporting back on matters communicated by those charged with governance.

50. The communication process will vary with the circumstances, including the size and governance structure of the entity, how those charged with governance operate, and the auditor's view of the significance of matters to be communicated. Difficulty in establishing effective two-way communication may indicate that the communication between the auditor and those charged with gov-

5. Circumstances in which the auditor should be informed of such consultations are described in paragraph 7 of SAS No. 50, *Reports on the Application of Accounting Principles*.
6. Comprehensive guidance on threats to independence and safeguards, including application to specific situations, is set forth in the AICPA's Conceptual Framework for AICPA Independence Standards.
7. In addition to entities subject to Securities and Exchange Commission reporting requirements, the Conceptual Framework for AICPA Independence Standards considers the following entities to be *public interest entities*: (1) employee benefit and health and welfare plans subject to Employee Retirement Income Security Act audit requirements; (2) governmental retirement plans; (3) entities or programs (including for-profit entities) subject to Single Audit Act OMB Circular A-133 audit requirements and entities or programs subject to similar program oversight; and (4) financial institutions, credit unions, and insurance companies. These entities are public interest entities because their audited financial statements are directly relied upon by significant numbers of stakeholders to make investment, credit, or similar decisions or indirectly relied upon through regulatory oversight (for example, in the case of pension plans, banks, and insurance companies) and, therefore, the potential extent of harm to the public from an audit failure involving one of these entities would generally be significant.

ernance is not adequate for the purpose of the audit (see paragraph 60).

Forms of Communication

51. The auditor should communicate in writing with those charged with governance significant findings from the audit (see paragraphs 34 and 35) when, in the auditor's professional judgment, oral communication would not be adequate. This communication need not include matters that arose during the course of the audit that were communicated with those charged with governance and satisfactorily resolved. Other communications may be oral or in writing.

52. Effective communication may involve formal presentations and written reports as well as less formal communications, including discussions. Written communications may include an engagement letter that is provided to those charged with governance.

53. In addition to the significance of a particular matter, the form of communication (for example, whether to communicate orally or in writing, the extent of detail or summarization in the communication, and whether to communicate in a formal or informal manner) may be affected by such factors as:

- Whether the matter has been satisfactorily resolved.
- Whether management has previously communicated the matter.
- The size, operating structure, control environment, and legal structure of the entity being audited.
- Legal or regulatory requirements that may require a written communication with those charged with governance.
- The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.
- The amount of ongoing contact and dialogue the auditor has with those charged with governance.
- Whether there have been significant changes in the membership of a governing body.
- In the case of a special purpose financial statement audit, whether the auditor also audits the entity's general purpose financial statements.

54. When a significant matter is discussed with an individual member of those charged with governance, for example, the chair of an audit committee, it may be appropriate for the auditor to summarize the matter in later communications so that all of those charged with governance have full and balanced information.

55. When the auditor communicates matters in accordance with this Statement in writing, the auditor should indicate in the communication that it is intended solely for the information and use of those charged with governance and, if appropriate, management and is not intended to be and should not be used by anyone other than these specified parties.

Timing of Communications

56. The auditor should communicate with those charged with governance on a sufficiently timely basis to enable those charged with governance to take appropriate action.

57. The appropriate timing for communications will vary with the circumstances of the engagement. Considerations include the significance and nature of the matter, and the action expected to be taken by those charged with governance. The auditor may consider communicating:

- Planning matters early in the audit engagement and, for an initial engagement, as part of the terms of the engagement.
- Significant difficulties encountered during the audit as soon as practicable if those charged with governance are able to assist the auditor to overcome the difficulties, or if the difficulties are likely to lead to a modified opinion.

58. Other factors that may be relevant to the timing of communications include:

- The size, operating structure, control environment, and legal structure of the entity being audited.
- Any legal obligation to communicate certain matters within a specified timeframe.
- The expectations of those charged with governance, including arrangements made for periodic meetings or communications with the auditor.
- The time at which the auditor identifies certain matters, for example, timely communication of a material weakness to enable appropriate remedial action to be taken.
- Whether the auditor is auditing both general purpose and special purpose financial statements.

Adequacy of the Communication Process

59. The auditor should evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. If it has not, the auditor should take appropriate action to address the effectiveness of the communication process. (See paragraph 62.)

60. As discussed in paragraph 8, effective two-way communication assists both the auditor and those charged with governance. Further, SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, identifies participation by those charged with governance, including their interaction with internal audit, if any, and external auditors, as an element of the entity's control environment. Inadequate two-way communication may indicate an unsatisfactory control environment, which will influence the auditor's assessment of the risks of material misstatements.

61. The auditor need not design specific procedures to support the evaluation required by paragraph 59. Rather, that evaluation may be based on observations resulting from audit procedures performed for other purposes. Such observations may include:

- The appropriateness and timeliness of actions taken by those charged with governance in response to matters communicated by the auditor.
- The apparent openness of those charged with governance in their communications with the auditor.
- The willingness and capacity of those charged with governance to meet with the auditor without management present.
- The apparent ability of those charged with governance to fully comprehend matters communicated by the auditor, such as the extent to which those charged with governance probe issues and question recommendations made to them.
- Difficulty in establishing with those charged with governance a mutual understanding of the form, timing, and expected general content of communications.
- Where all or some of those charged with governance are involved in managing the entity, their apparent awareness of how matters discussed with the auditor affect their broader governance responsibilities, as well as their management responsibilities.

62. If, in the auditor's judgment, the two-way communication between the auditor and those charged with governance is not adequate, there is a risk the auditor may not have obtained all the audit evidence required to form an opinion on the financial statements. The auditor should consider the effect, if any, on the auditor's assessment of the risks of material misstatements.

63. The auditor may discuss the situation with those charged with governance. If the situation cannot be resolved, the auditor may take such actions as:

- Modifying the auditor's opinion on the basis of a scope limitation.
- Obtaining legal advice about the consequences of different courses of action.
- Communicating with third parties (for example, a regulator), or a higher authority in the governance structure that is outside the entity, such as the owners of a business (for example, shareholders in a general meeting), or the responsible government agency for certain governmental entities.
- Withdrawing from the engagement.

DOCUMENTATION

64. When matters required to be communicated by this Statement have been communicated orally, the auditor should document them.[8] When matters have been communicated in writing, the auditor should retain a copy of the communication. Documentation of oral communication may include a copy of minutes prepared by the entity if those minutes are an appropriate record of the communication.

EFFECTIVE DATE

65. This statement is effective for audits of financial statements for periods beginning on or after December 15, 2006. (continued on page 92)

8. SAS 103, *Audit Documentation*, requires the auditor to document discussions of significant findings or issues with management and others (including those charged with governance) on a timely basis, including responses. That SAS also requires that the audit documentation include documentation of the significant findings or issues discussed, and when and with whom the discussions took place.

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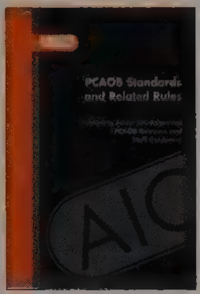

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APPENDIX A
REQUIREMENTS TO COMMUNICATE WITH THOSE CHARGED WITH GOVERNANCE IN OTHER STATEMENTS ON AUDITING STANDARDS

A1. Requirements for the auditor to communicate with those charged with governance are included in other Statements on Auditing Standards (SASs). This Statement does not change the requirements in:

a. Paragraph 17 of SAS No. 54, *Illegal Acts by Clients*, to communicate with the audit committee or others with equivalent authority and responsibility illegal acts that come to the auditor's attention.

b. Paragraph 22 of SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*, to communicate to management and the audit committee or others with equivalent authority and responsibility when the auditor becomes aware during an audit in accordance with generally accepted auditing standards that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement, and that an audit in accordance with generally accepted auditing standards may not satisfy the relevant legal, regulatory, or contractual requirements.

c. Paragraph 22 of SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, to inquire directly of the audit committee (or at least its chair) regarding the audit committee's views about the risks of fraud and whether the audit committee has knowledge of any fraud or suspected fraud affecting the entity.

d. Paragraph 79 of SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, to communicate with those charged with governance fraud involving senior management and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements. In addition, the auditor should reach an understanding with those charged with governance regarding the nature and extent of communications with those charged with governance about misappropriations perpetrated by lower-level employees.

e. Paragraph 20 of SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit*, to communicate in writing to management and those charged with governance control deficiencies identified during an audit that upon evaluation are considered significant deficiencies or material weaknesses.

APPENDIX B
QUALITATIVE ASPECTS OF ACCOUNTING PRACTICES

The communication in accordance with paragraph 34(a) of this Statement, and discussed in paragraphs 37 and 38, may include such matters as the following:

Accounting Policies

- The appropriateness of the accounting policies to the particular circumstances of the entity, considering the need to balance the cost of providing information with the likely benefit to users of the entity's financial statements. Where acceptable alternative accounting policies exist, the communication may include identification of the financial statement items that are affected by the choice of significant policies as well as information on accounting policies used by similar entities.
- The initial selection of, and changes in, significant accounting policies, including the application of new accounting pronouncements. The communication may include the effect of the timing and method of adoption of a change in accounting policy on the current and future earnings of the entity; and the timing of a change in accounting policies in relation to expected new accounting pronouncements.
- The effect of significant accounting policies in controversial or emerging areas (or those unique to an industry, particularly when there is a lack of authoritative guidance or consensus).
- The effect of the timing of transactions in relation to the period in which they are recorded.

Accounting Estimates

- For items for which estimates are significant, issues discussed in Statement on Auditing Standards (SAS) No. 57, *Auditing Accounting Estimates*, and SAS No. 101, *Auditing Fair Value Measurements and Disclosures*, including, for example:
  - — Management's identification of accounting estimates.
  - — Management's process for making accounting estimates.
  - — Risks of material misstatement.
  - — Indicators of possible management bias.
  - — Disclosure of estimation uncertainty in the financial statements.

Financial Statement Disclosures

- The issues involved, and related judgments made, in formulating particularly sensitive financial statement disclosures (for example, disclosures related to revenue recognition, going concern, subsequent events, and contingency issues).
- The overall neutrality, consistency, and clarity of the disclosures in the financial statements.

Related Matters

- The potential effect on the financial statements of significant risks and exposures, and uncertainties, such as pending litigation, that are disclosed in the financial statements.
- The extent to which the financial statements are affected by unusual transactions including nonrecurring amounts recognized during the period, and the extent to which such transactions are separately disclosed in the financial statements.
- The factors affecting asset and liability carrying values, including the entity's bases for determining useful lives assigned to tangible and intangible assets. The communication may explain how factors affecting carrying values were selected and how alternative selections would have affected the financial statements.
- The selective correction of misstatements, for example, correcting misstatements with the effect of increasing reported earnings, but not those that have the effect of decreasing reported earnings.

APPENDIX C
AMENDMENT TO "AN ENTITY'S ABILITY TO CONTINUE AS A GOING CONCERN" OF STATEMENT ON AUDITING STANDARDS NO. 59, *THE AUDITOR'S CONSIDERATION OF AN ENTITY'S ABILITY TO CONTINUE AS A GOING CONCERN*, AS AMENDED

C1. This amendment to Statement on Auditing Standards (SAS) No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, adds a requirement that the auditor communicate with those charged with governance events or conditions that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.

C2. Paragraph 17 of SAS No. 59 is inserted as follows, and subsequent paragraphs in SAS No. 59 are renumbered accordingly:

Communication With Those Charged With Governance

17. If, after considering identified conditions and events in the aggregate and after considering management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the auditor should communicate with those charged with governance:

a. The nature of the events or conditions identified.

b. The possible effect on the financial statements and the adequacy of related disclosures in the financial statements.

c. The effects on the auditor's report.

AMENDMENT TO "COMMUNICATIONS WITH THOSE CHARGED WITH GOVERNANCE AND MANAGEMENT" OF STATEMENT ON AUDITING STANDARDS NO. 108, *PLANNING AND SUPERVISION*

C3. This amendment to SAS No. 108, *Planning and Supervision*, is to conform to the requirements of this Statement.

C4. Paragraph 25 of SAS No. 108 is amended as follows:

Communication~~s~~ With Those Charged With Governance ~~and Management~~

25. *SAS No. 114, "The Auditor's Communication With Those Charged With Governance," requires the auditor to communicate with those charged with governance an overview of the planned scope and timing of the audit.* ~~The auditor may discuss elements of planning with those charged with governance and the entity's~~

~~management. These discussions may be a part of overall communications made to those charged with governance of the entity or may be made to improve the effectiveness and efficiency of the audit. Discussions with those charged with governance ordinarily include the overall audit strategy and timing of the audit, including any limitations thereon, or any additional requirements. Discussions with management often occur to facilitate the conduct and management of the audit engagement (for example, to coordinate some of the planned audit procedures with the work of the entity's personnel). Although these discussions often occur, the overall audit strategy and the audit plan remain the auditor's responsibility. When discussions with those charged with governance or with the entity's management of matters included in the overall audit strategy or audit plan occur, the auditor should be careful to not compromise the effectiveness of the audit. For example, discussing the nature and timing of detailed audit procedures with management might compromise the effectiveness of the audit by making the audit procedures too predictable.~~

This Statement entitled The Auditor's Communication With Those Charged With Governance *was unanimously adopted by the assenting votes of the 19 members of the board.*

The task force gratefully acknowledges the contributions of Diane Hardesty in the development of this Statement on Auditing Standards.

Note: *Statements on Auditing Standards are issued by the Auditing Standards Board, the senior technical body of the Institute designated to issue pronouncements on auditing matters. Rule 202,* Compliance With Standards, *of the Institute's Code of Professional Conduct requires compliance with these standards in an audit of a nonissuer.*

SSARS INTERPRETATION

Interpretation No. 28 of AR Section 100, *Compilation and Review of Financial Statements*

Interpretations of the SSARSs are Interpretative Publications pursuant to AR section 50, Standards for Accounting and Review Services. *Interpretative publications are not standards for accounting and review services. Interpretative publications are recommendations on the application of SSARSs in specific circumstances, including engagements for entities in specialized industries. An interpretative publication is issued after all ARSC members have been provided an opportunity to consider and comment on whether the proposed interpretative publication is consistent with the SSARSs.*

The accountant should be aware of and consider interpretative publications applicable to his or her compilation or review. If the accountant does not apply the guidance included in an applicable interpretative publication, the accountant should be prepared to explain how he or she complied with the SSARSs provisions addressed by such guidance.

28. Special-Purpose Financial Statements to Comply With Contractual Agreements or Regulatory Provisions

.109 *Question*—An accountant may be asked to compile or review special-purpose financial statements prepared to comply with a contractual agreement or regulatory provision that specifies a special basis of presentation. In most circumstances, these financial statements are intended solely for the use of the parties to the agreement, regulatory bodies, or other specified parties. How should the accountant modify the standard compilation or review report when reporting on these special-purpose financial statements?

.110 *Interpretation*—An accountant who is asked to compile or review special-purpose financial statements prepared to comply with a contractual agreement[16] or a regulatory provision that specifies a special basis of presentation[17] may issue a compilation or review report on those financial statements in accordance with SSARS 1, as amended [section 100], as described in this interpretation. This interpretation describes reporting on:

a. Special-purpose financial statements prepared in compliance with a contractual agreement or regulatory provision that does not constitute a complete presentation of the entity's assets, liabilities, revenues and expenses, but is otherwise prepared in conformity with generally accepted accounting principles or an other comprehensive basis of accounting.

or

b. A special-purpose financial presentation (may be a complete set of financial statements or a single financial statement) prepared on a basis of accounting prescribed in an agreement that does not result in a presentation in conformity with generally accepted accounting principles or an other comprehensive basis of accounting.

Financial Statements Prepared on a Basis of Accounting Prescribed in a Contractual Agreement or Regulatory Provision That Results in an Incomplete Presentation but One That Is Otherwise in Conformity With GAAP or an OCBOA

.111 An entity may engage an accountant to compile or review a special-purpose financial statement prepared in compliance with a contractual agreement or regulatory provision that does not constitute a complete presentation of the entity's assets, liabilities, revenues, or expenses, but is otherwise prepared in conformity with GAAP or OCBOA. For example, a governmental agency may require a statement of gross income and certain expenses of an entity's real estate operation in which income and expenses are measured in conformity with GAAP, but expenses are defined to exclude certain items such as interest, depreciation, and income taxes. Such a statement may also present the excess of gross income over defined expenses. Also, a buy-sell agreement may specify a statement of gross assets and liabilities of the entity measured in conformity with GAAP, but limited to the assets to be sold and liabilities to be transferred pursuant to the agreement.

.112 When the accountant submits compiled or reviewed special-purpose financial statements prepared on a basis of accounting prescribed in a contractual agreement or regulatory provision that results in an incomplete presentation but one that is otherwise prepared in conformity with GAAP or OCBOA, the accountant's report should be modified to include an explanatory paragraph with the following information:

- An explanation of what the financial statement is intended to present and a reference to the note to the special-purpose financial statement that describes the basis of presentation.
- If the basis of presentation is in conformity with GAAP or OCBOA, a statement that the presentation is not intended to be a complete presentation of the entity's assets, liabilities, revenues, and expenses.
- A separate paragraph at the end of the report stating that the report is intended solely for the information and use of those within the entity, the parties to the contract or agreement, the regulatory agency

16. A contractual agreement as discussed in this interpretation is an agreement between the client and one or more third parties other than the accountant.

17. When the contractual agreement or regulatory provision specifies the use of a prescribed form for which the accountant has been engaged to compile the financial statements identified therein, the accountant should reference SSARS 3, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms* [section 300], for an alternative form of standard compilation report when the prescribed form calls for a departure from generally accepted accounting principles or an other comprehensive basis of accounting.

with which the report is being filed, or those with whom the entity is negotiating directly, and is not intended to be and should not be used by anyone other than these specified parties.

.113 The following is an illustrative example of a compilation report on special-purpose financial statements:

> I (we) have compiled the accompanying statement of net assets sold of XYZ Company as of December 31, 20X1, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.
>
> A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). I (we) have not audited or reviewed the accompanying statement and, accordingly, do not express an opinion or any other form of assurance on it.
>
> The accompanying statement was prepared for the purpose of presenting the net assets of XYZ Company sold to ABC Company pursuant to the purchase agreement described in Note A, and is not intended to be a complete presentation of XYZ Company's assets and liabilities.
>
> This report is intended solely for the information and use of [*the specified parties*][18] and is not intended to be and should not be used by anyone other than these specified parties.

.114 The following is an illustrative example of a review report on special-purpose financial statements:

> I (we) have reviewed the accompanying statement of gross income and direct operating expenses of XYZ Company for the year ended December 31, 20X1, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in this statement is the representation of management (owners) of XYZ Company.
>
> A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.
>
> The accompanying statement was prepared for the purpose of presenting gross income and direct operating expenses of XYZ Company pursuant to the regulatory provision described in Note A, and is not intended to be a complete presentation of XYZ Company's income and expenses.
>
> Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying statement of gross income and direct operating expenses in order for it to be in conformity with generally accepted accounting principles.
>
> This report is intended solely for the information and use of [*the specified parties*][19] and is not intended to be and should not be used by anyone other than these specified parties.

Financial Statements Prepared on a Basis of Accounting Prescribed in an Agreement That Results in a Presentation That Is Not in Conformity With GAAP or an OCBOA

.115 An entity may engage an accountant to compile or review a special-purpose financial statement prepared in conformity with a basis of accounting that departs from GAAP or an OCBOA. A loan agreement, for example, may require the borrower to prepare consolidated financial statements in which assets, such as inventory, are presented on a basis that is not in conformity with GAAP or an OCBOA. Also, an acquisition agreement may require the financial statements of the entity being acquired (or a segment of it) to be prepared in conformity with GAAP except for certain assets, such as receivables, inventories, and properties for which a valuation basis is specified in the agreement.

.116 Financial statements prepared under a basis of accounting as discussed above are not considered to be prepared in conformity with an OCBOA because the criteria used to prepare such financial statements do not meet the requirement of being "criteria having substantial support," even though the criteria are definite.

.117 When the accountant submits compiled or reviewed special-purpose financial statements prepared on a basis of accounting prescribed in an agreement that results in a presentation that is not in conformity with GAAP or OCBOA, the accountant's report should be modified to include an explanatory paragraph with the following information:

- An explanation of what the presentation is intended to present and a reference to the note to the special-purpose financial statements that describes the basis of presentation.
- A statement that the financial statement is not intended to be a presentation in conformity with GAAP or an OCBOA.
- A description and the source of significant interpretations, if any, made by the Company's management relating to the provisions of a relevant agreement.
- A separate paragraph at the end of the report stating that the report is intended solely for the information and use of those within the entity, the parties to the contract or agreement, the regulatory agency with which the report is being filed, or those with whom the entity is negotiating directly, and is not intended to be and should not be used by anyone other than these specified parties. For example, if the financial statements have been prepared for the specified purpose of obtaining bank financing, the report's use should be restricted to the various banks with whom the entity is negotiating the proposed financing.

.118 The following is an illustrative example of a compilation report on special-purpose financial statements:

> I (we) have compiled the special-purpose statement of assets and liabilities of XYZ Company as of December 31, 20X1, and the related special-purpose statements of revenue and expenses and of cash flows for the year then ended in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.
>
> A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). I (we) have not audited or reviewed the accompanying statement and, accordingly, do not express an opinion or any other form of assurance on it.
>
> The accompanying special-purpose financial statements were prepared for the purpose of complying with the acquisition agreement between ABC Company and XYZ Company as discussed in Note A, and are not intended to be a presentation in conformity with generally accepted accounting principles.
>
> This report is intended solely for the information and use of [*the specified parties*][20] and is not intended to be and should not be used by anyone other than these specified parties.

.119 The following is an illustrative example of a review report on special-purpose financial statements:

> I (we) have reviewed the accompanying special-purpose statement of assets and liabilities of XYZ Company as of December 31, 20X1 and the related special-purpose statements of revenue and expenses and of cash flows for the year then ended in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of management (owners) of XYZ Company.
>
> A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, I (we) do not express such an opinion.
>
> The accompanying special-purpose financial statements were prepared for the purpose of complying with Section 4 of a loan agreement between DEF Bank and the Company as discussed in Note A, and are not intended to be a presentation in conformity with generally accepted accounting principles.
>
> Based on my (our) review, I am (we are) not aware of any material modifications that should be made to the accompanying special-purpose financial statements in order for them to be in conformity with the basis of accounting described in Note A.
>
> This report is intended solely for the information and use of the [*specified parties*][21] and should not be used by used by anyone other than these specified parties.

[Issue Date: December 2006.]

18. The report may list the specified parties or refer the reader to the specified parties listed elsewhere in the report.
19. The report may list the specified parties or refer the reader to the specified parties listed elsewhere in the report.
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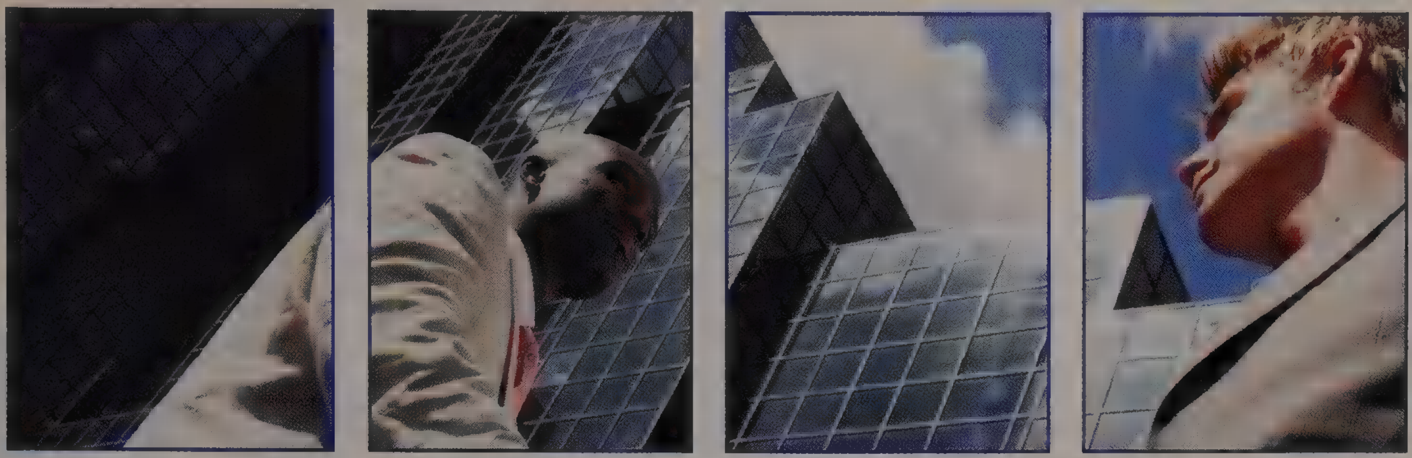

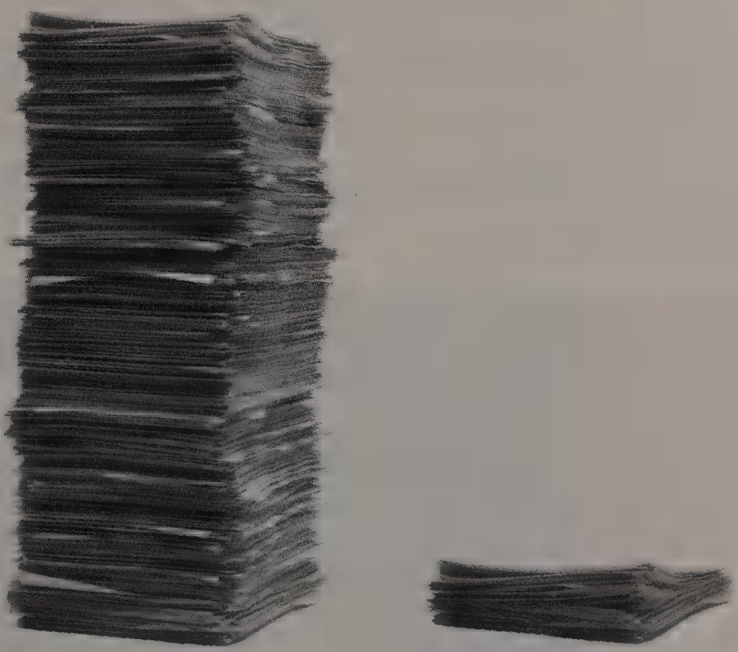

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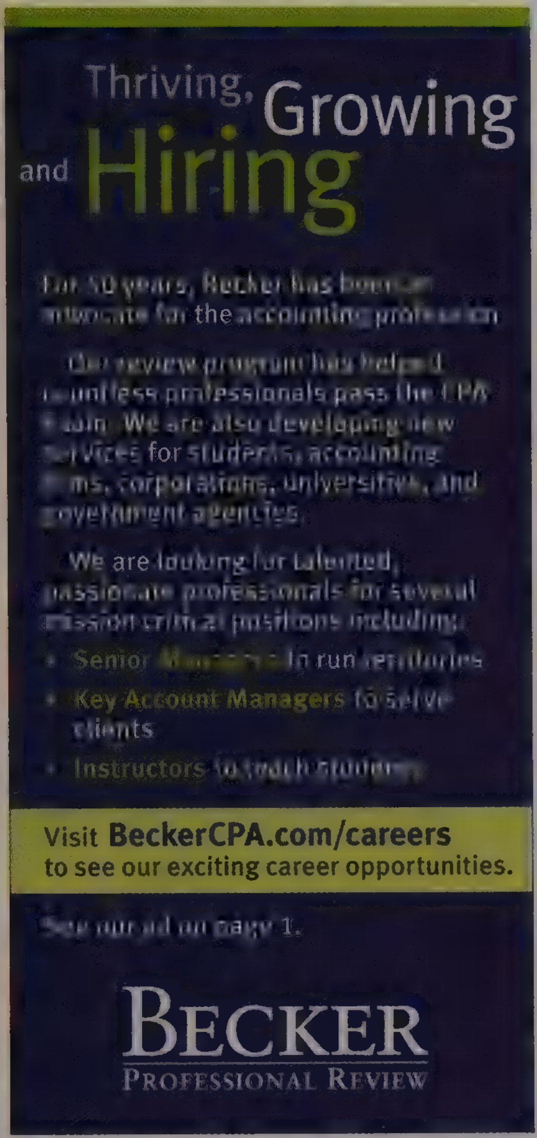

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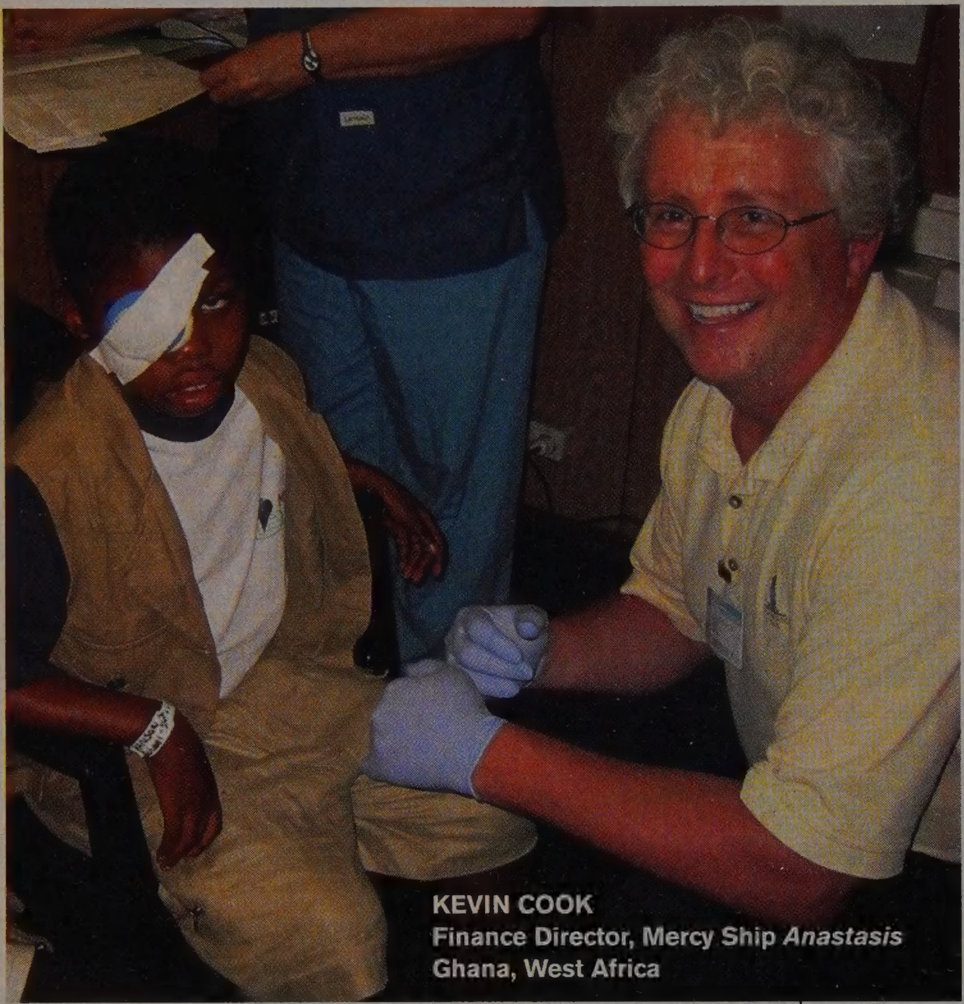

KEVIN COOK
Finance Director, Mercy Ship *Anastasis*
Ghana, West Africa

I'm the ship's finance director. My job is to make sure we have cash available in the field to meet the needs of the ship's ministries and its operating expenses. As a charitable organization, Mercy Ships must be able to demonstrate that we're putting as much as possible of our donors' contributions into our programs rather than into the operations of the ship.

My primary job on the *Anastasis* is to serve the 320-person crew that's here to help the people of Africa. We get involved in a lot of different programs, primarily medical, but also construction and well-drilling projects, and ministries involving local orphanages and prisons. My wife is involved with a team that teaches poor women how to support their families by growing and selling mushrooms.

In addition to my regular job I signed on as a member of the transport team. I had a young boy who came in with a cataract; I carried him down from the operating room to the ward after surgery and later took the bandage off his eye. He was able to see—he was so excited. You can't help but get excited, too, when you witness people who have their sight for the first time in a long time—or maybe the first time ever. That compensation is far greater than anything I ever received in industry.

I started in public practice and then became controller of a private manufacturing company in New England. I later became the CFO. I then was director of accounting for a large law firm until I went into full-time mission work with Mercy Ships in August 2004.

I wasn't really sure what CPAs could do in mission work. I thought I would be relegated to the United States and would not get out into the field. A friend of ours was a plumber with the same questions when he joined Mercy Ships. So I inquired, and found they needed help in the finance area in several locations, including West Africa. We're here in Ghana through the end of February. Then we're off to Liberia until November 2007 when the ship goes into dry dock. In early 2008 we're heading to Sierra Leone.

All the Mercy Ships people in the field are volunteers. We come from a variety of backgrounds—doctors, dentists, engineers, IT professionals, plumbers, electricians and even a hair stylist. In the Mercy Ships organization (**www.mercyships.org**) the staff and crew members pay the organization a fee to offset the cost of our food and cabin space on board. We receive support from churches, family and friends to help with our crew fees each month.

There's a tremendous need out here for finance people. People perform a variety of roles and stay anywhere from two weeks to several years. I have accounting positions available; if someone wants to come and work for six months, I would be tremendously happy—thrilled—to have an experienced person help.

—As told to Matthew G. Lamoreaux

Editor's note: Cook has been an AICPA member since 1977. His membership status is inactive while he serves in a volunteer capacity overseas.

PHOTOGRAPH BY PATTI COOK

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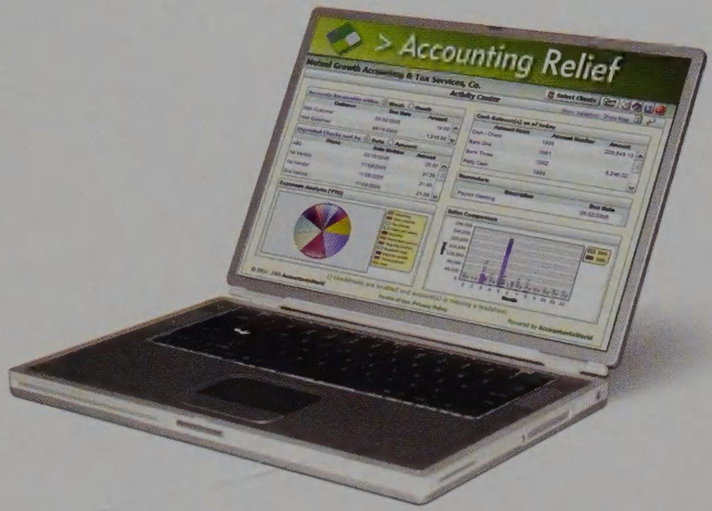

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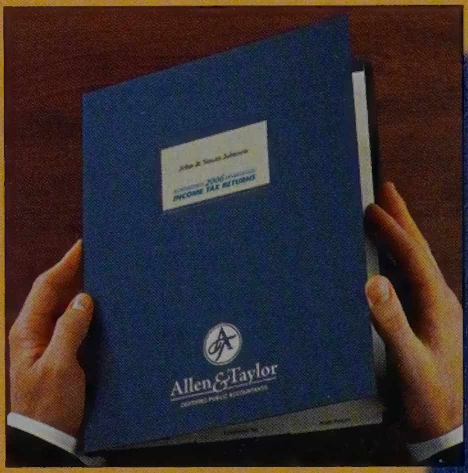

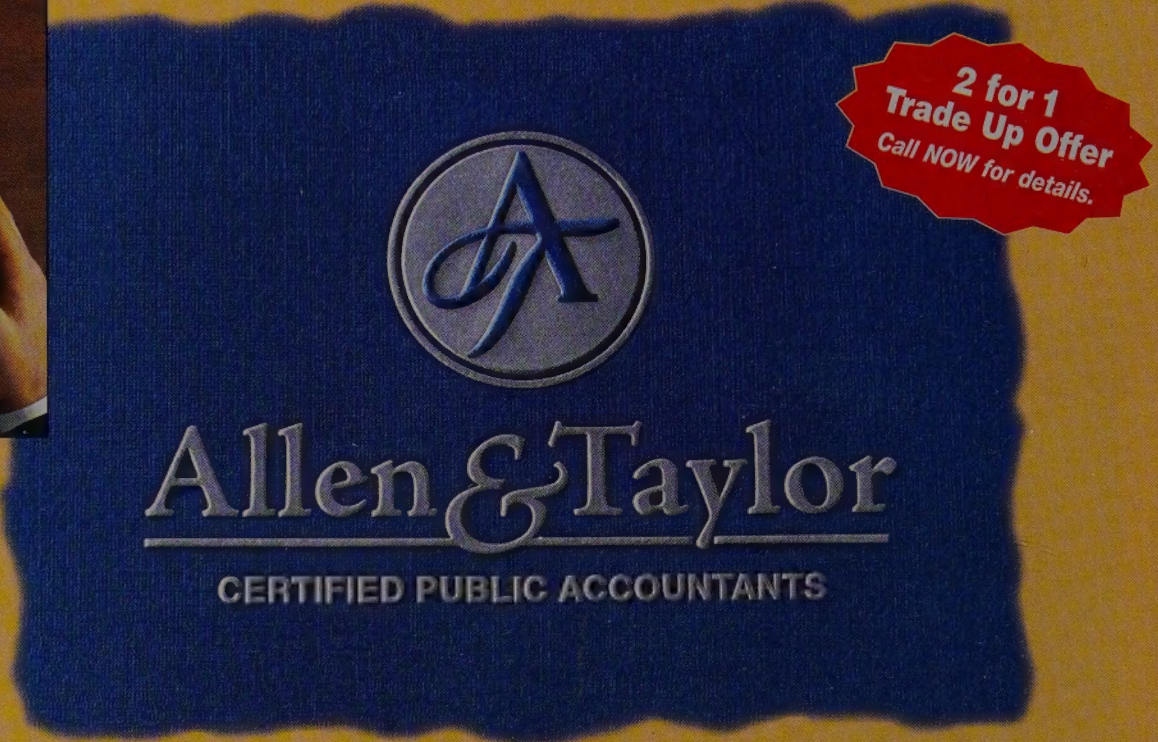

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